BALANCING OUTREACH AND SUSTAINABILITY: THE DOUBLE BOTTOM LINE OF MICROFINANCE IN ECUADOR

By

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TABLE OF CONTENTS

LIST OF TABLES

LIST OF ABBREVIATIONS

BCE	Banco Central del Ecuador
BNF	Banco Nacional de Fomento
CAF	Corporación Andina de Fomento
CEPESIU	Centro de Promoción y Empleo Para el Sector Informal Urbano
CERISE	Comité d'Echanges de Réflexion et d'Information sur les Systèmes d' Epargne-crédit
CFN	Corporación Financiera Nacional
CONAUPE	Corporación Nacional de Apoyo a las Unidades Populares Económicas
FEPP	Fondo Ecuatoriano Populorum Progressio
ICV	*Índice de condiciones de vida* (living conditions index)
IDB	Inter-American Development Bank
IESS	Instituto Ecuatoriano de Seguridad Social
MFI	Microfinance institution
NGO	Non-governmental organization
RFR	Red Financiera Rural
SBS	Superintendencia de Bancos y Seguros
SPI	*Sociedad popular de inversión* (popular investment society)
UNEPROM	Unidad Ejecutora del Programa Nacional de Microempresas
UNICEF	United Nations Children’s Fund
USAID	United States Agency for International Development

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Over the last two decades, microfinance has emerged as a significant element within the Ecuadorian financial system. Originally conceived as a tool for poverty alleviation, microfinance has evolved into a profitable, large-scale industry. Naturally, there are questions about the extent to which microfinance institutions can reach marginalized individuals while maintaining sustainable financial systems. Institutions now face a double bottom line in fulfilling social objectives and generating adequate financial returns.

This study examines that fundamental tradeoff within the Ecuadorian microfinance sector. Data have been analyzed from national studies on microenterprises, along with financial information reported by various institutions around the country. Semi-structured interviews were conducted with eight private-sector institutions in order to understand how institutional dynamics and sustainability concerns shape outreach policies. Two dimensions of outreach have been examined. The first dimension is the breadth of outreach, which refers to the geographic coverage of microfinance institutions and the incorporation of new clients. In recent years, the number of new clients at Ecuadorian microfinance institutions has grown, but much of the recent growth in the industry is derived from clients assuming higher amounts of debt. The second dimension is the depth of outreach, which refers to the extent to which poor individuals and

women are represented in microfinance programs. Generally speaking, non-governmental organizations are more likely to incorporate marginalized individuals than private microfinance banks and credit unions. Sustainability issues affect both the breadth and depth of outreach. This includes factors like competition, the regulation of interest rates, and the high cost of microfinance operations. These pressures sometimes cause institutions to scale back from financing smaller credit operations.

CHAPTER 1
INTRODUCTION

The recent expansion of microfinance around the developing world signals an attempt to improve economic livelihoods for the poor by providing greater access to financial resources. Nonetheless, there are still doubts about the extent to which microfinance reaches those individuals that suffer the greatest degree of economic exclusion. The greatest impediment confronting microfinance institutions (MFIs) is the need to balance social objectives with institutional sustainability. The impulse for self-preservation complicates efforts to incorporate a large number of economically marginalized individuals.

Outreach in microfinance—generally referring to the incorporation marginalized individuals—is a complex phenomenon that involves a myriad of competing interests and constraints (Hermes et al. 2008). This study elucidates the ways in which Ecuadorian MFIs navigate these tensions and determine which segments of the market they will serve. The analysis is organized along the major dimensions of outreach outlined by James Copestake (2005): breadth, depth, and sustainability. Breadth of outreach refers to the geographic coverage of microfinance and the number of clients incorporated. Depth of outreach refers to the inclusion of poor individuals and women. These two dimensions are each affected by the requirement that microfinance programs operate sustainably. MFIs must deal not only with the high cost of microlending, but also external pressures from government regulation and competition.

Through quantitative and qualitative analysis, this study examines these dimensions of outreach within the Ecuadorian context. Much of the quantitative data is derived from a 2004 survey by the United States Agency for International Development (USAID), which collected information from more than 17,000 microentrepreneurs around the country. Respondents provided an extensive array of information surrounding the personal characteristics of the

respondent, the characteristics of the microenterprise, the microenterprise's sales and earnings, and credit activity, among other things. The survey allows for a great deal of analysis on the depth of outreach of microfinance, especially with respect to the socioeconomic status of microfinance clients and women's access to credit. The survey's major shortcoming is that it only includes respondents from urban areas with at least 5,000 inhabitants, so it says relatively little about financial coverage in the rural sector. Quantitative institutional data are derived largely from the publications of the Red Financiera Rural, an organization of 49 Ecuadorian MFIs that works to expand financial services to the rural and urban population as a sustainable means of combating poverty. Quarterly and annual reports provide financial data and social outreach indicators for each MFI.

This study also involves a series of semi-structured interviews with eight private-sector MFIs—two banks, one regulated credit union, three unregulated credit unions, and two non-governmental organizations (NGOs)—all of which are based in the northern highlands of Ecuador. Table 1-1 provides information about the missions and unique attributes of each institution. In general, some institutions emphasize poverty alleviation as a primary objective, while others stress economic development or quality financial management and sustainability.

This study begins with an overview of the development of Ecuadorian microfinance and later examines each dimension of outreach in greater detail. Chapter 2 reviews the impressive rise of Ecuador's microfinance sector over the last few decades. In many ways, the development of Ecuadorian microfinance mirrors the challenges and characteristics of microfinance around the world. For this reason, I analyze the Ecuadorian case simultaneously with broader global trends in microfinance, emphasizing points of convergence and divergence. I also examine studies on microfinance's contributions to national economic development, along with impact

studies on the effectiveness of microfinance as a poverty alleviation tool. Chapter 3 considers the breadth of outreach in terms of the recent expansion of institutional coverage and the persistent difficulty of reaching rural clients. Closely associated with the latter is the use of specialized microcredit methodologies, which can be harnessed to expand outreach to previously neglected areas. Chapter 4 examines the depth of outreach, specifically the issue of poverty outreach and the incorporation of women. Chapter 5 considers the effects of sustainability on outreach, considering issues such as the regulation of interest rates, increasing competition in the market, and over-indebtedness. Chapter 6 provides conclusions on the major findings of the research.

As Ecuador's microfinance sector continues to grow, it is increasingly important that practitioners and government agencies examine the extent to which microfinance is accessible to economically marginalized individuals. Addressing this question requires insights into both the economic disadvantages confronting microentrepreneurs and the constraints facing institutional credit providers. I analyze these issues by integrating information on microenterprises and the financial institutions that serve them. The case studies reveal the heterogeneous approaches adopted by MFIs that determine institutional outreach.

Table 1-1. General information on microfinance institutions in the study[1]

Institution (type)	Mission statement	Attributes	Loan portfolio, Sept. 2010
Artesanos (unregulated credit union)	"Provide the best products and services that contribute to the social and economic development of our associates, allowing improvement in their quality of life, through multidisciplinary management and personnel, efficient and committed with top technological support and excellent administration."	Artesanos was established in Ibarra in 1991. It originally served the city and the surrounding rural cantons, where financial services were scarce. In the past two years, Artesanos has experienced some growing pains. The institution has been opening new branches around the province, so it has raised interest rates to the maximum rates allowed by the Central Bank. During 2009, credit policies were relaxed, and the institution experienced a spike in arrearage. Since that time, Artesanos has demanded more strict requirements and stronger credit histories from its clients.	$4,523,226

[1] All translations in this document are my own.

Table 1-1. Continued

Institution (type)	Mission statement	Attributes	Loan portfolio, Sept. 2010
Banco Procredit (private bank)	"Procredit Bank is a development-oriented full-service bank. We offer excellent customer service and a wide range of banking products. In our credit operations, we focus on lending to very small, small and medium-sized enterprises, as we are convinced that these businesses create the largest number of jobs and make a vital contribution to the economies in which they operate. Unlike other banks, our bank does not promote consumer loans. Instead we focus on responsible banking, by building a savings culture and long-term partnerships with our customers. Our shareholders expect a sustainable return on investment, but are not primarily interested in short-term profit maximisation. We invest extensively in the training of our staff in order to create an enjoyable and efficient working atmosphere, and to provide the friendliest and most competent service possible for our customers."	Banco Procredit entered the microfinance market in 2001. It is a branch of Germany's Procredit Holding, which has operations in 22 developing countries around the world. Procredit has recently reoriented its focus toward larger microenterprises and small enterprises. As a result, they recently increased the minimum loan amount to a relatively high $2,000. The bank argues that microenterprises are capable of generating substantial returns and that poverty should be fought with subsidies, not credit.	$243,560,307

Table 1-1. Continued

Institution (type)	Mission statement	Attributes	Loan portfolio, Sept. 2010
Banco Solidario (private bank)	"We are an Ecuadorian institution that helps reduce poverty and improve the living conditions of less favored segments of the population by meeting their needs for high quality, innovative financial services. We reward the trust of our depositors, investors, shareholders, and collaborators with financial, social, and environmental profitability that is the result of competitive management by an upright, responsible, supportive, and enthusiastic team, whom adopt these principles as part of their life mission."	Banco Solidario was the first private bank to enter the microfinance market in 1995. It is an affiliate of the group ACCION International, which has microfinance branches operating all over Latin America. The institution stresses the need to generate profits in order for microfinance to be a viable activity.	$257,490,241
Casa Campesina de Cayambe (NGO)	"We are an institution that promotes sustainable Integral Human Development of the poor and excluded population. In strategic alliance with national and international institutions: we administer plans, programs, and projects that develop the abilities and initiatives of the population in order to be protagonists and actors in their own well-being with a focus on rights and inter-cultural mixture. We seek optimization of the available resources and the continual improvement of our services through a qualified team, dedicated and inspired by the Salesian spirit."	Casa Campesina de Cayambe has operated in the canton of Cayambe, Pichincha since 1987. The organization is part of the Catholic Salesian Society, and it works with rural indigenous communities in the area. The organization offers a range of credit products for production activities, education, and healthcare.	$2,743,743

Table 1-1. Continued

Institution (type)	Mission statement	Attributes	Loan portfolio, Sept. 2010
CEPESIU (NGO)	"Promote sustainable development with equity, promoting improvement in the local economy, fomenting the development of micro- and small enterprises, and strengthening the institutionality that supports them."	CEPESIU (Centro de Promoción y Empleo para el Sector Informal Urbano) has operated in Ecuador since 1983. The institution provides a great deal of training and technical assistance, often relying on external funding from Europe and the United States. They have notably been working to form *sociedades populares de inversión* (SPIs)—savings and loan groups that maintain autonomous control over the administration of group funds.	$1,318,596
Codesarrollo (regulated credit union)	"Codesarrollo is a savings and credit cooperative with social vision that looks for the integral development of marginal sectors of Ecuador, rural and marginal-urban dwellers, Afro-Ecuadorians and indigenous people through the promotion and strengthening of local financial markets, with the goal that these people can access agile and just financial services."	Codesarrollo has operated in Ecuador since 1998. It was purchased by the Grupo Social FEPP (Fondo Ecuatoriano Populorum Progressio), which maintains majority ownership in the institution. FEPP, as an NGO, cannot accept deposits, so they harnessed the credit union structure as a means of collecting savings. Codesarrollo works largely with group lending, but it specializes in lending to local financial structures that operate in rural and marginal urban areas. FEPP provides technical assistance and training to the staff of those financial structures.	$51,245,936

Table 1-1. Continued

Institution (type)	Mission statement	Attributes	Loan portfolio, Sept. 2010
Maquita Cushunchic (unregulated credit union)	"We are a financial entity maintaining principals of ethics and solidarity. We believe in the capacity of our members and contribute to their social economic development through providing guidance for their financial decisions and offering appropriate solutions to their needs."	Maquita Cushunchic operates 5 branches in Quito. Co-founded by a Catholic priest in 1998, the credit union arose primarily out of the need for women's access to credit in the southern part of the city. It is continuing to expand and plans to open new branches outside of the city in the near future.	$11,939,470
Mujeres Unidas (unregulated credit union)	"We are an important savings and loan cooperative for organizational entities, specializing in meeting economic needs and local initiatives for women and families in the marginal urban and rural sector, along with projects for small enterprises in the northern highlands of Ecuador, supplying competitive interest rates, social assistance, and agile services to build a better country."	Mujeres Unidas has been operating out of Ibarra since 2001. Started by a group of largely-female economists, the institution adopted the mission of providing training, technical assistance, and savings and credit to small organizations of women. In the beginning, as much as 90% of its clientele were women, but that figure has dropped to about 65 to 75% in recent years. This is largely a function of efforts to open up access to credit for male family members.	$2,867,695

Sources: MIX Market 2011a; RFR 2010a; UCACNOR 2011.

CHAPTER 2
THE DEVELOPMENT OF MICROFINANCE IN ECUADOR

Microfinance has become a major global phenomenon in recent decades. Ecuador's microfinance sector is undoubtedly a part of that movement, but it presents its own distinctions. The most significant difference is that microfinance did not arise from the "upscaling" of NGOs into formal financial institutions, which was often the case in other countries in Latin America (Marulanda and Otero 2005, 4). Instead, a few major microfinance banks entered the Ecuadorian market and brought microfinance into the mainstream within a relatively short period of time. Also, Ecuador's industry emerged largely without the aid of subsidies, requiring that private sector MFIs adhere to sustainable practices and policies.

This chapter examines the development of the Ecuadorian microfinance sector within the context of the global microfinance movement. First, I consider the origins of microfinance and explore the scholarship concerning its effectiveness as a tool for alleviating poverty and promoting economic growth. Second, I review the development of microfinance at the regional level. Third, I examine the effects of macroeconomic volatility on Ecuadorian microenterprises and financial markets. Fourth, I illustrate the main characteristics of microenterprises in Ecuador. Finally, I examine credit use among Ecuadorian microentrepreneurs and the perception of credit as a positive means for business growth.

Global Issues in Microfinance

The recent microfinance movement is often credited to Muhammad Yunus and the Grameen Bank, which was initiated in 1976 (Yunus 2003). Microcredit was fashioned as an alternative to the parasitical moneylenders that operated extensively throughout rural Bangladesh. Women entrepreneurs depended heavily on such middlemen to procure raw materials for weaving, agriculture, and other activities. Exorbitant interest rates severely

constricted investment opportunities for productive activities. By providing lower interest rates and more transparent information, MFIs became a viable alternative to informal moneylenders. Microfinance is unique as a poverty-alleviation tool because it transfers many of the risks and responsibilities to the poor themselves. From a supply-side perspective, microfinance is desirable because it is a relatively self-sustaining practice. Since microcredit is channeled toward gain-seeking economic activities, institutions can expect that most clients will be able to repay a loan. This is not the case for other forms of subsidized assistance to the poor.

One significant transformation in recent years has been the shift from "microcredit" to "microfinance." The former refers only to the concession of credit while the latter implies a much wider range of products and services, such as insurance and pension plans. There has also been greater emphasis on savings, with some arguing that it should be promoted as a precondition for receiving credit (Wright 2000, 130). Not only do savings bolster an institution's equity structure, but they also allow households to build funds for investment, retirement, and other major expenditures (Armendáriz and Morduch 2010, 174). Savings may have a protective function, allowing individuals to handle crises and emergencies when they occur. They can also be effective in smoothing consumption to cover short-term needs (Johnson and Rogaly 1997, 44). Furthermore, savings can be used by individuals who do not need or do not qualify for credit (Vonderlack and Schreiner 2001).

Microenterprises are small-scale businesses that have relatively minor capital investment. Some argue that microenterprises may have a greater utility for credit than larger businesses, since low-capital businesses have a wider array of possible investment options than larger businesses (CGAP 2002a). This argument centers on the principle of diminishing marginal returns to capital, in which initial investments in a business generate greater proportional returns

than investments in highly-capitalized businesses (Armendáriz and Morduch 2010, 5–6). Nonetheless, many microenterprises are concentrated in economic activities that offer few opportunities for growth, so microcredit may not produce much of a stimulative effect on the business.

Poverty generally arises from a lack of human, physical, and financial capital that prohibits an individual from sustaining an adequate level of well-being (Khandker 1998; Wright 2000, 7–9). Microfinance is built upon the premise that access to financial services can improve business activities and, in turn, improve individual well-being. Robinson (2001, 6) perceives financial services as a positive means of increasing business productivity, smoothing consumption and income flows, enlarging and diversifying businesses, and increasing incomes. Credit may allow microentrepreneurs to maintain adequate levels of capital investment during emergencies and crises.

In a sustainable microcredit program, credit goes only to those entrepreneurs who have the requisite skills to generate sufficient cash flows. Otherwise, microentrepreneurs must rely upon entrepreneurial training programs, or business development services, in order to correct for human capital deficiencies. Robinson (2001) cites two problems arising from training linked to credit programs: the cost of training hinders the sustainability of the program, and clients report that the programs provide little value. Also, the economically active poor generally understand their own business constraints, so training programs have to address their specific needs in order for the training to be valuable. Business development services used to be a mainstay in early Latin American microfinance programs, but the industry has increasingly “unbundled” microcredit from those related services (Goldmark 2006).

Impact studies provide mixed signals about the extent to which microfinance reduces poverty. In a study involving clients from the Grameen Bank and two similar microfinance programs, Morduch (1998) finds that microcredit does not reduce poverty per se, but it may reduce vulnerability by smoothing income. The study involved a cross-sectional survey of 1,798 households from 87 Bangladeshi villages in 1991–1992. Data were collected at three points during the year, following the rice harvests. Participation in a microcredit program was associated with much lower variation in labor supply and consumption across seasons, but it did not generate any significant increases in per capita consumption or school enrollment for children. Anecdotal evidence suggests that borrowers were using credit to purchase land, rather than to complete short-term projects, so it may take more time for the benefits of microcredit to materialize. However, while examining the same survey results, Pitt and Khandker (1998) found that marginal consumption levels were positive for microcredit program participants in Bangladesh. The study utilized weighted exogenous sampling maximum likelihood-limited information maximum likelihood-fixed effects (WESML-LIML-FE) methods. The results indicate that for every 100 taka borrowed, annual household consumption expenditure increased by 18 taka for women and 11 taka for men.

Credit may not be an effective tool for the poorest of the poor, since they will invariably spend those funds on subsistence needs (Greeley 2005). This raises some doubts about the potential for microfinance programs to direct their efforts toward poverty alleviation. Traditional MFIs rarely reach the bottom 10 to 15% of the population (Wright 2000). Institutions that do not adopt concrete policies for targeting the poor tend to drift toward higher-income clients over time (CGAP 2001).

Microfinance in Latin America

Ecuador's microfinance industry is a relatively recent example of a wider regional trend. Bolivia and Peru were some of the first countries in Latin America to develop major microfinance sectors. Some of the major international organizations that established branches in Latin America later initiated operations in Ecuador. ACCION International—which is partnered with Banco Solidario (established in 1995) and Credife of Banco del Pichincha (established in 1999)—has been working in Latin America since the 1970s. By 1994, FINCA was already operating in five other countries in the region before it began operations in Ecuador. Banco Procredit (established in 2001) already had operations in Bolivia and Nicaragua. The experiences with microfinance in those countries shaped the development of Ecuador's industry.

During the late 1990s, various MFIs in the Andean region suffered from the application of consumer credit methodologies with microentrepreneurs. Consumer credit is dedicated toward the acquisition of consumer durables. Such loans are approved through a methodology known as scoring, which utilizes actuary formulas to determine the appropriate loan amount and schedule of payments that a client can reasonably assume. Scoring utilizes a point system for various indicators of risk, such as the economic sector in which the client is employed, the longest period of arrears for the previous loan, the applicant's credit history, and whether the applicant has savings (Schreiner 2009). These methods appeal strongly to banks because they tend to be heavily centralized and maintain large databases of client records. Scoring streamlines operational costs, allowing institutions to save at least 3 to 4% of the loan portfolio (Freytag 2009). Scoring methods may work best when used to complement individualized client evaluations. Schreiner (2009, 212–13) provides three reasons for why scoring does not replace the usual screening process: 1) less information is available about poor microentrepreneurs who lack experience with institutional credit; 2) loan officers can measure qualitative characteristics

of an applicant that scoring would not be able to consider; and 3) few institutions store data on rejected applicants, who may have been rejected for qualitative reasons.

Scoring methods do not translate well in microcredit, since they assume that all clients have incomes and financial behaviors that are stable and predictable. During the 1980s, Chilean banks began promoting large-scale consumer credit, and many other countries in the Andean region followed suit (Marulanda 2006). Bolivian MFIs made the mistake of using scoring methods with low-income microentrepreneurs, who cannot rely upon a steady income stream (Rhyne 2001). When the country entered an economic recession in the late 1990s, it became readily apparent that the institutions had underestimated the risks involved. The resulting repayment crisis emphasized the need for financial systems to distinguish between consumer loans and microcredit.

The Ecuadorian microfinance sector was slower than Peru and Bolivia in incorporating consumer credit. This is largely what spared Ecuador from the consumer credit crisis. Guachamín Guerra and Cárdenas Martínez (2007, 39–40) argue that the crisis may have enervated the enthusiasm for the development of microfinance in Ecuador. By 2002, Ecuador's Superintendencia de Bancos y Seguros (SBS) began to distinguish between microcredit and consumer credit. MFIs are increasingly offering consumer loan products as a means of remaining competitive, though these represent only a small minority of loans at most institutions. Nonetheless, the industry should refrain from the wholesale adoption of consumer credit scoring methods, since microentrepreneurs face volatile business cycles and cannot rely upon a fixed stream of cash flows over time.

Macroeconomic Volatility

Ecuador's oil boom in the 1970s engendered two paradoxical changes: high macroeconomic growth and rapidly increasing external indebtedness. The subsequent lost decade

entailed a precipitous decline in living standards. In the wake of such pressing needs, some farmers' associations and financial institutions began attending to clients typically abandoned by the major banks (Castillo Añazco 2009, 7). Financial institutions were damaged by liquidity problems and the loss of confidence in the sucre—the national currency before dollarization. The loss of confidence in the banking system benefitted the credit unions, as citizens lost confidence in the banking sector (Gutiérrez García 2009).

The Ecuadorian government, along with a number of external actors, began to generate programs for financing microenterprises. During the late 1980s and 1990s, the Inter-American Development Bank (IDB) promoted its "Global Program for Microenterprise Credit," co-financing a credit program with the government. Beginning in 1986, the government made efforts to support financing for street vendors and microenterpreneurs who lacked access to formal credit. The state created the Unidad Ejecutora del Programa Nacional de Microempresas (UNEPROM), which provided training and credit through support by the USAID, the United Nations Children's Fund (UNICEF), and the national government (Jácome and Cordovez 2004, 46–47). It held a weak presence in the market until it was dissolved in 1997. The Corporación Nacional de Apoyo a las Unidades Populares Económicas (CONAUPE) was initiated in 1988, as a parallel program to UNEPROM.

Some public financial institutions remain viable today. The Corporación Financiera Nacional (CFN) works to support the growth of all productive and services sectors. In 1992, under pressure by the IDB and the Corporación Andina de Fomento (CAF), it became a second-tier institution, defined as an institution that captures funds from external lenders in order to finance its operations. The CFN has developed various microcredit programs that target a diverse set of needs (Jácome and Cordovez 2004, 50–52; Jordán Bucheli and Román Ferrand 2004, 39–

43). Another major public institution is the Banco Nacional de Fomento (BNF), which was created to serve a variety of economic activities, though it has traditionally focused on production activities and agriculture. Recently, they have been offering housing loans through their "555 Program"—5% interest, 5-year maximum term, $5,000 maximum loan amount.

In 1999, Ecuador experienced a major crisis that reverberated throughout the country's political and economic system. The roots of the crisis came from a variety of exogenous shocks: falling oil prices, damage from El Niño, and the financial crises of Brazil, Russia, and East Asia. The decline in oil prices hurt a government that had become heavily dependent on oil exports as a source of public revenue; this ultimately encouraged the acquisition of unsustainable levels of external debt. Concerns remain about Ecuador's dependency on the oil sector, which has increased its share of GDP from less than 10% in the early 1990s to 20% in 2007 (Economist Intelligence Unit 2009a, 3). In 1999, real GDP had fallen 7.3%, and the sucre lost two-thirds of its US-dollar value (Beckerman 2002, 17). In January 2000, the government dollarized the economy in an attempt to avert hyperinflation, stem capital flight, and allow interest rates to fall (Economist Intelligence Unit 2009a, 3).

The crisis had a pronounced social impact, increasing levels of poverty and inequality. The poverty rate increased by 12% from 1995 to 1998 and 9% during 1999 (Parandekar et al. 2002, 127). It was not until 2004 that personal income returned to its 1998 level. Unemployment peaked at 14% in 1999. The crisis was particularly destabilizing for women's employment. A study from 1998–2003 found that subemployment affected about 50% of women and 25% of men in 2003. Women received wages that were 13.4% lower than those of men, *ceteris paribus* (Larrea Maldonado 2004, 59). Wages for women were 20% lower than men for informal work and 42% lower for domestic service.

From 2000 to 2002, the government created a number of microcredit programs directed toward various ethnic groups and economic sectors. These programs were run by the Ministerio de Bienestar Social, the Ministerio de Agricultura y Ganadería, the Ministerio de Relaciones Laborales y Humanos, and some other autonomous agencies at the national level. All of the programs developed by these agencies sought common objectives: generate employment, strengthen local institutions, configure local financial markets, distance microfinance from traditional state paternalism, implement new lending methodologies, generate sustainability in microfinance, open up access to excluded segments of the population, coordinate programs among local microcredit structures, and implement best-use practices among microfinance programs (Jácome and Cordovez 2004, 58–59).

The recent global economic crisis has not been catastrophic for the Ecuadorian microfinance sector. According to Javier Vaca, the Executive Director of the Red Financiera Rural (RFR),

> The recent global economic crisis of 2008 has not had a major structural impact on the microfinance sector, but it precipitated a deceleration for the industry as a whole. Growth until 2008 approached levels around 10%, while in 2009 members of the RFR had a growth rate of less than 1%… It was not just the issue of how the crisis affected businesses but also the diminished flow of remittances for many credit unions that are funded by remittances in Ecuador… Also issues like some tax charges, like the tax on the transference of foreign currency, which made international credit more expensive for institutions that have international credit… So it made it such that an international loan carried a cost around 3% (Vaca 2010). [1]

The NGO Casa Campesina de Cayambe reported a decline in foreign sources of credit, since international credit often comes from the United States and Europe where the crisis was very strong.

[1] Ecuador's RFR is a financial network comprised of microlenders from across the country. The RFR requires that member institutions be engaged in microfinance activities for at least 50% of their operations. Members operate in urban and/or rural areas. Membership within the RFR may indicate a preoccupation with financial sustainability and outreach, which could generate distortions when analyzing the national microfinance sector as a whole.

Microenterprises in the Ecuadorian Economy

Microenterprises are an increasingly visible part of the Ecuadorian economy.[2] There is a wide range of estimates of the number of microenterprises operating in Ecuador, largely due to inconsistencies in how to define a microenterprise. The 2001 census shows that Ecuador has about 950,000 microenterprises. An extensive 2004 study by the USAID (2005, 11–12) estimates that there are probably 640,000 to 700,000 urban microenterprises, which employ around 1,018,135 individuals—about 25% of the country's urban workforce.

Sales from microenterprises represented about 26% of gross domestic product in 2004; urban microenterprises generated sales of approximately $6.03 billion and earned $2.36 billion in net income (USAID 2005). Microenterprises make a substantial contribution to household welfare. About 76% of microenterprises contribute to at least half of all household income, while 42% generate all household income (USAID 2005, 31). Many microentrepreneurs work in the informal sector. Informality is generally defined by a surplus supply of labor and a lack of productive resources to complement labor (Mezzera 1989). Only about one-quarter of Ecuadorian microenterprises are registered with tax authorities and hold a municipal license, and only about 15% are registered with the national social security system (USAID 2005, 32–34). Poor microentrepreneurs are ill-equipped to handle the bureaucratic constraints, legal procedures, institutional discrimination, and time and resource demands that are necessary to achieve formal status (ILO 1998; Soto 1989).

[2] There is no consensus definition of a microenterprise. In the 2004 study on microenterprises in Ecuador, the USAID defines a microenterprise as a "personal or family business in commerce, production, or services that employs less than 10 persons, is owned and operated by an individual, family, or group of individuals of relatively low income, whose owner exercises independent judgment on products, markets, and prices, and that is an important—if not the most important—source of income for the household" (USAID 2005: XVII). The SBS maintains that a microloan totals no more than $20,000, and annual sales for the business may not exceed $100,000. Institutions also have subjective interpretations on what characterizes a microentrepreneur. A small NGO like CEPESIU only finances loans to a maximum of $3,000, arguing that clients who demand more than that may have graduated from the status of being microentrepreneurs. At major banks like Banco Solidario and Banco Procredit, a loan of $20,000 may be considered a microloan.

The reasons why microentrepreneurs start businesses vary over time (Table 2-1). During the 1990s and early 2000s, increasingly fewer individuals were starting businesses in order "to be independent" or "to continue a family business." On the other hand, they were more likely to cite the "opportunity to earn more" or the ability "to combine home and work." This latter reason applies largely to women—17% of all female respondents versus 2% of male respondents. Other reasons remained fairly constant over time: to continue a family business, lack of salaried employment, lack of other options, and age. Very few respondents started a business due to a lack of opportunities in the labor market, as less than 10% of respondents reported either being unable to find a salaried job or having no other available options.

The microenterprise sector presents only modest opportunities for increasing employment in the long term. Microenterprises are best-viewed as sources of self-employment, as 69% of businesses employ no additional workers (USAID 2005, 37). Among businesses that have employed workers in the past, 25% of those jobs were either temporary or part-time. Businesses that have operated for a longer period of time are more likely to have employed workers or assistants, representing 45% of businesses more than 15 years old compared with 22% of those operating for less than one year (USAID 2005, 38). The average number of employees tends to be the highest in economic subsectors like chemicals and construction materials (2.64 workers), construction (2.37), metal products (2.16), and textiles (2.13). It tends to be lowest in transportation (1.38), commerce (1.48), and food products (1.76). These low-employment subsectors account for 67% of all microenterprise activities, while the commerce sector represents 55% of all microentrepreneurs.

Microentrepreneurs report a variety of problems confronting their businesses. According to the 2004 USAID survey, the most pressing problem for microentrepreneurs has been

competition, accounting for more than a quarter of all responses (Table 2-2). About 9% of all clients reported that the business had little demand or few clients. Another main issue is the lack of funds for investment or operations, which was reported by 17% of respondents. This indicates that access to financial services could be a useful tool, but not a panacea, for microenterprise growth. About 2% of respondents acknowledge the inability to obtain credit as a main problem for the business. Less than 0.02% of respondents reported that high interest rates were a main problem for the business.

Microentrepreneurs generally do not rely upon the formal financial sector for credit, with only 29% holding a savings account and 16% having applied for a loan in the past 12 months (USAID 2005, 127). About half of those who had not applied for a loan in the past 12 months reported that they either had no need for credit (14%) or did not want to become indebted (37%).

Microcredit is typically not utilized for start-up costs. Business start-ups are highly volatile in the first few months of operation. As a result, microcredit tends to come in the form of short-term working capital loans for established businesses, rather than credit for the acquisition of long-term assets. Working capital loans may be used to acquire short-term assets, like inventory. Fixed assets, such as buildings and equipment, are generally funded through savings.

Family and personal savings represent the most dominant source of financing for the initiation of a new business (Dávila 2003). According to the 2004 USAID survey, 67% of microentrepreneurs use personal savings as the primary source of start-up capital for the business (Table 2-3). Loans or gifts from family or friends represent the second most reported source of start-up capital, accounting for more than 19% of respondents. Credit from lending institutions is a primary source of start-up capital for only about 6% of respondents.

Informal moneylending has a very negative image around the world because of numerous examples of usurious lending practices. Nonetheless, informal credit presents a number of favorable attributes, namely its convenience and the ability to use personal information as a substitute for physical collateral or documented credit histories while reducing transactional costs (Ghate 1992). Informal loans can come from a variety of sources—landlords, local traders, employers, commodity wholesalers, and pawnbrokers, among others—many of which have direct economic ties with the borrower (Robinson 2001, 16). Informal moneylenders, known as *chulqueros* in Ecuador, have a relatively minor presence in Ecuadorian credit markets, providing only 4% of all credit in 2004 (USAID 2005).

Microfinance Institutions in Ecuador

The Ecuadorian microfinance sector features a broad array of institutional structures, the largest of which are private banks, regulated and unregulated credit unions, and microfinance NGOs. Banks are unique in that they are usually backed by profit-seeking investors. Credit unions typically arise within communities and emphasize savings-first requirements. NGOs often emphasize social objectives, and their most prominent institutional constraint arises from the inability to collect savings, since there is no way to insure deposits when the institution has no at-risk capital (White and Campion 2002, 26–28).

Large-scale microfinance emerged in Ecuador during the mid-1990s to the early-2000s. In 1995, Banco Solidario, an affiliate of the global organization ACCION International, became the first private microfinance bank to enter the financial system. Credife, the microfinance subsidiary of Banco del Pichincha, was initiated in 1999, and Banco Procredit was established in 2001. Large-scale finance offers a range of positive benefits: 1) the ability to achieve economies of scale; 2) the possession of resources, sophistication, and regulatory approval to offer a wide range of products; 3) greater diversification of the portfolio and funding sources due to their

broader geographic coverage; 4) branch networks provide greater convenience to clients in terms of proximity; and 5) the relative ease of regulating one large institution instead of many small ones (Westley and Branch 2000, 25–26).

Institutions generally tend to take one of two views when interpreting the role of microfinance in the economy. First, some view microfinance is a means of subverting the sources of exclusion, or credit rationing, which confront small-scale enterprises. This segment is considered to perform productive activities that make a valuable contribution to the economy. Procredit Holding, which has operations in Ecuador, has adopted this mission to a great extent:

> Our mission as a bank is to effectively contribute to the development a country, to its performance… I will continue to work with [small-scale] operations, while also looking to finance primarily production and export activities, which are things that contribute directly to the mission that we want—to contribute effectively to the country's development (Villaseca 2010).

Other institutions, like the NGO CEPESIU, maintain that microfinance should be used as a tool for improving livelihoods:

> CEPESIU is an entity that puts about 50% of its efforts into microfinance and the other 50% in promoting the economic development of the poorest population. We have development programs that work toward the improvement of business management, improvement in local economies, the promotion of collective enterprises, and improvement in the business environment for small producers (Padilla 2010).

It has become increasingly apparent that access to credit is only one means of increasing incomes for the poor, and it may not be suitable in all cases. Jácome and Cordovez (2004) argue that microfinance has been important in Ecuador's economic development but not effective as a tool for reducing poverty. Only a minority of microentrepreneurs applies for and obtains institutional credit, largely among the wealthiest segments.

Discussion

Microfinance has emerged within the last few decades as a tool for combating poverty and social exclusion in the developing world. There are mixed signals about the extent to which microcredit improves incomes, but it may smooth incomes by reducing the volatility of capital investment over time. The expansion of microinsurance and savings products may help households manage crises and emergencies more effectively. Microenterprises are small-scale businesses that employ no more than 10 workers. Many poor individuals around the world rely upon microenterprises to sustain livelihoods. Credit may be an effective tool for those enterprises that lack funds for necessary capital expenditures. While there is no consensus view on the effectiveness of microfinance in reducing poverty, credit is probably not a viable tool for the poorest of the poor, who will invariably use credit to purchase basic necessities. Credit is only viable for those businesses which already generate enough cash flows to finance a loan.

The development of Ecuadorian microfinance has been a direct result of the recent global microfinance movement, the origins of which are typically traced to Bangladesh's Grameen Bank. While small-scale savings and credit associations have a long history in Ecuador, large-scale MFIs did not emerge until the 1990s. Those institutions often have ties to global organizations that promote microfinance in the developing world. There remains a great deal of variability in terms of how institutions interpret the role of microfinance in the Ecuadorian economy, whether as a tool for economic development or poverty alleviation.

The 1999 economic crisis increased unemployment and poverty around the country. In the financial sector, the public lost a great deal of confidence in banks, which faltered from liquidity problems. Over the next decade, MFIs established an important presence in the market.

Only a minority of Ecuadorian microentrepreneurs has credit from a formal institution, even though many businesses reported a need for greater financing; this suggests that there is a

large potential market for microfinance services. Savings were the primary source of funding for start-up costs, while institutional credit was used about 6% of the time.

Ecuador's microfinance sector is comprised of an array of institutions, namely private banks, credit unions, and NGOs. Certain patterns emerge across institutional forms. Microfinance banks are established with private investor capital and tend to be profit-oriented. Many such banks in Ecuador were initiated by commercial lenders or international microfinance organizations. Credit unions generally arise within local communities and have savings-first requirements. NGOs cannot collect savings, and they tend to have a greater orientation toward social objectives. Of course, there are exceptions to these general trends.

Table 2-1. Reasons for establishing a microenterprise in Ecuador, 2004

	Year the microenterprise was initiated					
Reason for starting business	1950-1988	1989-1995	1996-1999	2000-2002	2003-2004	Total
To be independent	45.8%	45.4%	39.4%	35.6%	30.7%	38.9%
Opportunity to earn more	33.7%	34.8%	38.8%	39.0%	42.7%	38.0%
To continue a family business	5.3%	3.6%	2.7%	2.3%	1.7%	3.0%
Couldn't find a salaried job	4.5%	4.1%	5.6%	4.9%	5.1%	4.8%
Only thing available	4.8%	4.4%	3.8%	4.9%	5.0%	4.6%
Because of age	0.9%	1.4%	1.3%	2.1%	2.2%	1.6%
To combine home and work	4.9%	6.3%	8.5%	11.3%	12.7%	9.0%

Notes: $p<.01$. Source: Calculated from USAID 2004.

Table 2-2. Main problems confronting Ecuadorian microenterprises, 2004

Main problem for the business	Total
Too much competition, many similar products	27.1%
Lack of funds for investment or operations	17.1%
Doesn't have problems	15.6%
Little demand, few clients	8.9%
The economic situation	4.2%
Difficulty with space and facilities	3.3%
Other personal or family problems	2.2%
Can’t obtain credit	2.2%
High cost of raw materials	2.2%
Difficult to locate raw materials	1.6%
Cheaper competing products	1.4%
Other (various)	14.3%

Notes: p<.01. Source: Calculated from USAID 2004.

Table 2-3. Most important source of start-up capital for Ecuadorian microenterprises, 2004

Source of start-up capital	Total
Personal savings	67.2%
Loans from family or friends	12.3%
Gifts from family or friends	6.9%
Payout from salaried position	3.5%
Bank or finance company	3.0%
Inheritance	2.3%
Credit union	2.2%
Moneylender	1.6%
NGO, foundation, etc.	0.6%
Remittances	0.1%
Other cooperative	0.1%
Lottery, other prize	0.1%

Source: Calculated from USAID 2004.

CHAPTER 3
BREADTH OF OUTREACH

Even though only a minority of microentrepreneurs access institutional credit, the microfinance sector has grown quite rapidly in recent years. Between 2002 and 2005, the gross microcredit portfolio for the country grew nine times its initial size. Estimates suggest that there are perhaps more than 500 MFIs in Ecuador, either regulated or unregulated by the SBS (IDB 2006, 22). These overall figures are rather impressive, but they mask serious imbalances in terms of the distribution of microfinance services throughout the country. Those imbalances are pronounced at the provincial level and especially in rural areas. The high cost of microlending encourages institutions to concentrate in cities that can support an institutional structure. Expanding into the rural sector demands that institutions adapt their credit policies and methodologies to accommodate the idiosyncrasies of rural finance.

This chapter examines the growth and distribution of microfinance services in Ecuador. I analyze the expansion of microfinance services throughout the country. Credit unions have been especially important in broadening the frontiers of microfinance. They have also been the dominant provider of financial services in rural areas, where poverty tends to be the strongest. I also consider the use of non-traditional lending methodologies, which figure prominently in the expansion of microfinance. Group lending methodologies are often used in rural areas or areas that have few institutional sources of financing.

The Expansion of Ecuadorian Microfinance

Over the past two decades, some Ecuadorian MFIs have grown dramatically while others have grown incrementally. Nonetheless, overall growth for the industry has been impressively high. Data from 34 MFIs indicate a period of rapid growth between 2005 and 2009, during which

the aggregate loan portfolio increased by 112% (Table 3-1).[1] This figure far outpaces the growth of the number of active borrowers at those institutions (46%). This indicates that individual borrowers are carrying higher amounts of credit than before. In 2005, the average credit balance per borrower was $1,337; by 2009, the average balance increased to $1,945. Thus, the growth of the loan portfolio is not a reliable indicator for explaining the incorporation of new clients by Ecuadorian MFIs.

Nonetheless, growth in the number of clients is still quite impressive. This is especially true among NGOs and credit unions, which experienced much higher growth than the private banking sector both in terms of loan portfolio and active borrowers. The 14 NGOs included in Table 3-1 more than tripled their aggregate loan portfolio between 2005 and 2009, while the number of active borrowers increased by 153% during that period. The 16 credit unions in the sample grew by 147% in loan portfolio and 80% in terms of active borrowers during the same period. For the four private banks in the sample, the total loan portfolio grew by 90%, while the number of active borrowers grew by less than 15%.

Ecuador's largest MFIs account for a high number of borrowers. Banco Solidario, for example, now serves more than 126,000 clients with a loan portfolio of $216 million (MIX Market 2011a). Among the 43 MFIs that reported financial information to the MIX Market in 2009, the five largest institutions accounted for nearly 55% of the total borrowers and 60% of the aggregate loan portfolio (MIX Market 2010a).

In terms of geographic coverage, microcredit is relatively concentrated in the highlands, accounting for 59% of credit by regulated institutions in 2009 (SBS 2009). The coastal region

[1] These figures are derived from the Microfinance Information Exchange (MIX) Market, which aggregates financial and social indicators from MFIs around the world. Membership in the MIX Market may imply that member institutions are concerned about financial performance, so the growth trends in this data sample may be stronger than one would find with the institutions that were not part of the sample.

received about 38% of the microcredit from regulated institutions, while the Amazon region received 3%.[2] These figures are roughly correlated with the distribution of microenterprises throughout the country. According to the 2001 census, about 48% of microenterprises were located in the highlands, 45% in the coastal region, and 6% in the Amazon region (Table 3-2).

The current distribution of microcredit by regulated institutions is more equitable than it was in 2005, when the highlands controlled over 72% of the microcredit portfolio. This reflects a general trend in which larger MFIs are gradually expanding operations to provinces that previously garnered little attention, including some of the poorest provinces in the country (Table 3-3). A number of provinces, including the largest provinces of Guayas and Pichincha, experienced fluctuations in their share of the regulated microcredit portfolio from 2005 to 2009. Among the 24 provinces included in Table 3-3, 16 provinces held a larger share of the portfolio in 2009 than in 2005. This trend applies especially to the least-populated provinces.

Large-scale institutions generally concentrate in major urban centers where there is a sizeable market for microfinance. Opening new locations around the country is costly. Banco Procredit, which has operated in Ecuador since 2001, is one of the newest banks to emerge in the microfinance sector. Establishing the infrastructure, constructing new offices, and building a client base all place tremendous financial pressures on the bank. The Director of Credit, Oscar Villaseca, explains the challenges facing the institution:

> First, we are a growing bank. In order to grow you need to invest… Second, the bank's financial cost is high. We work with external sources, a large part of which come from CAF and the IDB. Internal financing is there but in a way it does not add up because we are a new bank… People trust the traditional banks like Pichincha, Banco de Guayaquil, Banco Bolivariano… Funding for those banks come principally from internal savings… We have a cost of funds of 6 to 7%, which is a disadvantage because Credife has a cost of funds of 2% (Villaseca 2010).

[2] These figures are affected by the graduation of unregulated institutions to regulated status during the period, as well as the liquidation of regulated institutions.

Credife is a subsidiary of Banco del Pichincha, which operates in every province in Ecuador. Since Banco del Pichincha has operations around the country, Credife was able to take advantage of the bank's institutional development and initiate microfinance operations at a large scale while avoiding the costs that other MFIs would confront.

Savings and loan cooperatives, or credit unions, are important sources of financing for microentrepreneurs in Ecuador and Latin America. They provide about 80% of microfinance services in Latin America and 70% of services in Ecuador (Economist Intelligence Unit 2009b; Jordán Bucheli and Román Ferrand 2004, 18). More than 1,000 credit unions operate at the national level, accounting for the greatest geographic coverage of all financial institutions (RFR 2009).

Westley and Branch (2000, 25–26) argue that credit unions are more adept than banks in a number of ways: their flexibility in adapting to local needs and circumstances, their relatively low costs that allow them to operate in rural communities, and their ability to maintain focus on their target populations by building close ties with poor individuals and small communities. Credit unions provide a greater degree of flexibility than other types of informal savings and loan groups in which members take turns sharing a savings pot.

Credit unions have the longest history of any financial structure in Ecuador, making them precursors to modern microfinance. In 1879, Guayaquil's Sociedad de Artesanos Amantes del Progreso became the first major cooperative structure in the country. Many of the early credit unions were promoted by members of the Socialist and Liberal Parties as well as the Catholic Church (Gutiérrez García 2009, 28). During the Alliance for Progress period of the 1960s and 1970s, a number of credit unions were created, particularly in the rural sector, by USAID and the Peace Corps with the active participation of the Catholic Church. Today, credit unions are

regulated by the Dirección Nacional de Cooperativas or the SBS. The Dirección Nacional de Cooperativas, an entity within the Ministerio de Inclusión Económica y Social, oversees the legal compliance of credit unions with less than $1 million in assets and $200,000 in savings deposits. The SBS controls those credit unions that exceed those amounts.

Credit unions differ from other MFIs in a number of ways. They generally are not established as "microfinance institutions," so they tend to serve a broader client base and target individuals within the community where the credit union operates. Of course, there are exceptions to these basic generalizations, especially among the more developed credit unions. For example, the credit union Codesarrollo has operations around the country and lends money to small financial entities in various local communities. Also, the credit union Mujeres Unidas now has operations throughout the northern provinces of Ecuador. Both Codesarrollo and Mujeres Unidas harnessed the credit union structure in order to fulfill a social mission at a national and regional level. Unlike NGOs, credit unions are able to collect deposits and build an equity base upon borrower savings.

Rural Finance

Ecuadorian MFIs largely operate in urban areas. Banco Solidario, for example, provides about 20% of its loans to rural areas, but only 3% of all loans finance agricultural activities (Durán 2010). Direct lending to individual clients entails a more significant effort in rural areas. The credit union Mujeres Unidas cites the challenges of synchronizing communication across its more isolated branches in the province of Imbabura (Palacios 2010). Many sparsely-populated areas lack the capacity to support an institutional structure.

Rural microfinance also demands that MFIs adapt their products to fit the needs of their clients. The typical working capital loan is designed for relatively short production cycles. Agricultural loans require payment periods and conditions that are tailored to the timing of the

harvests. Informal lending is common in rural finance, either from neighbors and family members or small-scale savings and loan structures, and local information is frequently used to assess the reliability of the borrower (Robinson 2001, 160–61).

Credit unions have been the dominant source of financing for the rural sector in Ecuador. Da Ros (2003) explains that state agricultural banks performed poorly during the 1980s, plagued by cumbersome procedures, politicized management, tendencies to serve medium- and large-scale producers, high administrative costs, and the use of funds for non-agricultural activities.

Lending to the rural sector is different from urban microlending because of the timing of cash flows from production, requiring that institutions devise loan products in which repayments are synchronized with the harvest and sale of goods. Agricultural activities are affected by the length and seasonality of the production cycle. Commerce and manufacturing activities tend to have relatively short business cycles, allowing them to repay loans relatively quickly. For this reason, microcredit has traditionally involved short-term, working capital loans. Agricultural production cycles, on the other hand, are dictated by the type of crop being produced as well as any other factors that may influence the timing of revenue from such production. All of the institutions in this study that regularly provide credit for agricultural activities demonstrate flexibility with respect to payment schedules.

Agricultural activities are subject to certain unique exogenous risks, like climactic shocks, that urban microenterprises do not face. Nonetheless, some MFIs view agriculture as a more stable and predictable activity, especially considering the high failure rate for microenterprise start-ups. The credit union Mujeres Unidas attributes their low arrearage rate to the institution's focus on serving agricultural workers (Janeth Palacios 2010). The NGO Casa Campesina de Cayambe has streamlined its application process, since there is clear information about prices for

agricultural products and livestock. Unlike other MFIs, Casa Campesina does not have to visit the client and carry out a full analysis of the enterprise.

Lending Methodologies

Perhaps the most distinctive characteristic of the global microfinance movement has been the development of group lending methodologies as a means of subverting collateral requirements. Traditional collateral requirements conflict with the objectives of microfinance, given that few microentrepreneurs own major assets. As a result, microfinance institutions have been required to innovate and devise novel lending schemes that mitigate the higher risk involved in servicing those clients. Group lending methodologies were implemented in Bangladesh's Grameen Bank and El Salvador's Fedecrédito during the late 1970s, each having a major influence on the development of microfinance in Latin America (Berger 1989; Rhyne 2001; Yunus 2003). Alternative lending methodologies expand the breadth of outreach of microfinance because they open up access to individuals that do not meet collateral requirements at formal financial institutions.

Lending groups operate under a solidarity guarantee in which individual clients are restricted from future access to credit when another member fails to repay, ultimately incentivizing clients to pay their debts on time and to seek other reliable borrowers (Otero 1986; Yunus 2003). There are three types of liability in modern microfinance: 1) individual liability, in which clients are liable only for their own debts; 2) joint-voluntary liability, entailing individual responsibility for the repayment of loans while restricting access to future loans should group members fail to repay their own debts; and 3) mandatory-joint liability, in which the group is fully liable for the repayment of all member loans (Braverman and Guasch 1993, 58). Joint-voluntary liability is much more prevalent than mandatory-joint liability, since it provides a degree of internal pressure for repayment without placing undue burden on the clients.

There are two principal subsets of group lending in microfinance: solidarity group lending and village banking. Solidarity groups are typically comprised of three to twenty members (Trezza 2006, 25). Funds are administered by the institution, and group members have regular meetings to discuss the use of their loans and the status of their business activities. Village banking involves financing larger groups of borrowers, which may encompass between ten and thirty members (Armendáriz and Morduch 2010, 114). These groups typically maintain autonomous control over the administration of funds.

Group lending can generate a number of direct and indirect benefits for clients. Kabeer (2005) argues that groups operate upon a notion of collective achievement, characterized by personal trust and social capital. The group form can benefit individuals who have traditionally been excluded from social networks and confronted asymmetrical bargaining power in business dealings. Groups often consist of individuals who live in close proximity to each other but who may not have had much previous interaction with each other. In that respect, groups may serve in unifying communities and building new social networks. Working collectively may also foster a greater sense of efficacy and political assertiveness, an aspect that is often cited as a source of women's empowerment.

Economically vulnerable individuals are viewed as risky clients, pressuring institutions to obtain information about the reliability of those individuals. Group lending is built upon the use of local information to reduce moral hazard (Stiglitz 1990). It is said that self-formed groups generate assortative matching, whereby reliable clients are likely to coalesce and mitigate adverse selection by avoiding riskier individuals (Armendáriz and Morduch 2010, 104).

Evidence from Ecuador casts some doubt on the effectiveness of assortative matching. The NGO CEPESIU utilizes solidarity group lending in about 50% of its operations. Many solidarity

groups are formed among family members, indicating that group formation is not always governed by clinical self-interest (Albán 2010). As a result, groups may not be composed of members with similar risk profiles even if they know a great deal about each other. Some studies have found that social ties do not guarantee high repayment rates (Abbink et al. 2006; Wydick 1999).

Group lending can be ineffective if applied in inappropriate circumstances. In order for assortative matching to occur, clients must have information about other potential group members. Casa Campesina de Cayambe can take advantage of peer monitoring techniques since it operates in small indigenous communities, but large microfinance banks work in highly dynamic urban areas where community solidarity may be less commonplace.

In Ecuadorian microfinance, group lending methodologies have never established a major presence. The industry developed during a time when individual lending was becoming more commonplace around the world. Many Ecuadorian MFIs rely on credit risk centers that compile individual credit histories. Also, some institutions utilize dynamic incentives, by which clients receive higher loan amounts in the future if they repay their current debts. The NGO CEPESIU, for example, employs a graduated scale by which clients can ascend to higher loan amounts over time. Clients start with a $500 maximum loan and work toward $3,000, the highest amount offered by the institution (Albán 2010).

Among 44 MFIs in Ecuador's RFR, individual loans accounted for more than 93% of the total loan portfolio among major private sector lenders in June 2010 (Table 3-4). In gross figures, about $1.27 billion of the $1.35 billion aggregate portfolio is dedicated to servicing individual-liability loans. Solidarity-group lending accounts for 2.4% of the total share, while village banking represents 3.7%. Group lending appears underrepresented in the data because their loan

amounts are generally smaller than individual-liability loans. Credit unions and private banks allocate more than 94% of their loan portfolio toward individual credit. However, NGOs tend to diversify their lending methodologies. Among the 14 NGOs in Table 3-4, only 57.3% of the loan portfolio is allocated to individual credit, while solidarity group lending accounts for 12.2% and village banking accounts for 30.1%.

The general proclivity for village banking over solidarity group lending contrasts with the general trend in Latin American microfinance, in which solidarity group lending is more prevalent than village banking (Berger 2006, 14).[3] From an institutional perspective, village banking may offer more stability than solidarity groups. Armendáriz (1999) argues that increasing group size reduces monitoring costs, encourages greater self-monitoring, and increases internal commitment due to the fear of strategic default among group members. Larger groups are also shown to be more effective in averting default with the institution, even if individual members fail to repay. These ideas resonate with Ecuador's Codesarrollo, which concentrates on fortifying preexisting financial structures within rural and marginal urban communities. In the 13-year history of the institution, only one local financial structure has been in arrears on a loan (Mazón 2010). Also, the size and autonomy of these structures allows Codesarrollo to charge comparatively low interest rates.

A number of Ecuadorian MFIs that work in rural areas employ group lending methodologies, such as the bank FINCA, the credit unions Mujeres Unidas and Codesarrollo, and the NGO Casa Campesina de Cayambe. Grouping clients allows institutions to reduce costs by transferring certain responsibilities to the clients (i.e., screening, monitoring, and enforcing obligations).

[3] This regional figure may be inflated by the presence of a few major lenders that employ village banking methodologies for most if not all of their operations, such as the global organization FINCA and Mexico's Compartamos.

Some institutions have also been promoting new forms of group finance. In addition to solidarity group loans, the NGO CEPESIU and the bank FINCA have formed a number of SPIs—autonomous savings and loan groups in which members retain control over the collection of savings and the distribution of loans. SPIs were originally developed by the Comité d'Echanges de Réflexion et d'Information sur les Systèmes d' Epargne-crédit (CERISE), a French NGO. There are four major objectives of SPIs: 1) outreach to poor and excluded areas, 2) adaptation of products and services for the target population, 3) the provision of benefits for clients, and 4) social responsibility of the institution (FINCA 2010, 4). Unlike a village bank, which maintains links with a financial institution, SPIs are self-regulated and employ their own savings. There are indications that the program is working well, as some groups have amassed capital in excess of $70,000 (Domenech 2010). SPIs may have great potential in communities that have not yet been reached by financial institutions.

Group lending methodologies may not be as adaptable to conditions in Ecuador as they are in Asia. Grameen-style methodologies demand at least three major requirements: 1) high demographic concentration, 2) subsidies for initial operational costs, and 3) well-defined limits on small amounts and long payment periods (COSUDE 2007, 8). These conditions can be prohibitive in Ecuador, a country where the rural population is relatively scattered. In terms of demographic concentration, Bangladesh has a population density of 1,013 persons per square kilometer, compared with 51 persons per square kilometer in Ecuador (Berger 2006; COSUDE 2007, 9). Ecuador also lacks state subsidies for microfinance institutions, as was the case during the early years of the Grameen Bank and state-funded microfinance banks like Indonesia’s Bank Rakyat Indonesia.

Individual-liability loans have been supplanting group credit around the world in recent years. Some major lenders have held from the beginning that individual lending can be a successful model for microfinance. The best example would be Germany's Procredit Holding, which operates in Ecuador and several other developing countries around the world. During the 1980s, the company posited that microfinance could work on an individual basis by developing strict policies for the evaluation and monitoring of clients (Rhyne 2001). This strategy has been generally successful, though it may not be suitable in all circumstances.

Macroeconomic downturns may also contribute to the concentration of individual loans. Economic crises generate a breakdown of the solidarity guarantee when members become less able to support each other (González-Vega 2003; Rhyne 2001, 97).Banco Solidario employed solidarity group lending until the early 2000s, when the economic crisis motivated them to reevaluate the sustainability of group-based lending.

Client preferences are also important in encouraging the widespread use of individual credit. Evidence from around the world indicates that group lending tends to fall out of favor as financial markets develop. Lenders are increasingly offering individual credit as an alternative to the rigid protocol of group lending programs, which can become time-consuming and costly for the client. For example, a study from Bolivia revealed a case in which a group spent nearly four times as many hours in preparing to receive a loan as one would encounter in a standard individual lending situation (Armendáriz and Morduch 2010, 123). In some cases, clients spend a great deal of time attending group meetings, which raises the effective cost of the loan (Park 2001, 45). As markets achieve some level of maturity in their supply of financial services, group lending methodologies appear too rigid and cumbersome to clients that now have more options (Cull et al. 2008a). Rhyne and Christen (1999, 19) have observed a disappearance of the so-

called “yellow pajamas” myth, or the idea that “clients would respond to nearly any requirement that microfinance programs imposed, even standing outside in yellow pajamas.”

Armendáriz and Morduch (2010, 127) note that institutions are often swayed to explore alternative solutions when a group goes into default. The NGO CEPESIU follows this pattern. About 18% of their loans are individual-liability, but almost all of them arose from some kind of group default. They explain that the institution attempts to accommodate reliable clients that have an unfavorable experience with a group, so individual loans represent a fallback alternative for those clients (Albán 2010).

Discussion

The microfinance industry has grown rapidly in the last decade. MFIs have grown more in terms of the total loan portfolio than the number of clients incorporated, suggesting that clients are taking out larger amounts of debt than before. Large-scale microfinance in Ecuador is generally geared toward urban microenterprises and tends to be concentrated around major metropolitan areas. This is largely a function of the difficulty of expanding institutional infrastructure to low-density rural communities. Credit unions provide about 70% of microfinance services in the country and are the most significant providers of financial services in rural areas, since they often arise from local needs and community networks. Rural finance requires loan products that are flexible to the cash flows of all clients. Agriculture usually requires a longer payment period than short-term working capital loans.

Group lending methodologies are an important means of expanding the frontiers of microfinance to incorporate new clients. These methodologies allow institutions to transfer the burden of screening and monitoring clients to the members of a group. This innovation has been a central part of the global microfinance movement, but it is less utilized in Ecuador. In recent years there has been a high concentration of individual credit along with a widespread use of

solidarity guarantees, meaning that Ecuadorian MFIs are relying largely upon credit histories and dynamic incentives that encourage the repayment of loans. The proclivity to offer individual credit does not indicate an abandonment of social objectives per se. However, group lending methodologies remain a viable tool for reaching rural areas, which are generally more difficult for MFIs to access. The industry is currently experimenting with alternative group finance models, like SPIs, which provide an even greater degree of autonomy to rural credit groups than traditional village banks. Nonetheless, these efforts currently remain outside of mainstream microlending.

Table 3-1. Growth of the loan portfolio and active borrowers for 34 Ecuadorian microfinance institutions, 2005–2009

Institution (count)	Loan portfolio 2005	Loan portfolio 2009	Rate of growth	Active borrowers 2005	Active borrowers 2009	Rate of growth
Private bank (4)	$377,839,355	$718,347,752	90.1%	276,265	316,524	14.6%
Credit union (16)	$157,859,000	$390,157,232	147.2%	88,136	158,301	79.6%
NGO (14)	$21,245,185	$71,581,016	236.9%	52,143	131,852	152.9%
Total (34)	$556,943,540	$1,180,086,000	111.9%	416,544	606,677	45.6%

Source: Elaborated by author from MIX Market 2011a.

Table 3-2. Geographic distribution of microenterprises in Ecuador's 2001 census

Region	Number of microenterprises: Urban	Rural	Total	Rural-urban distribution of microenterprises: Urban	Rural
Coast	585,373	327,477	912,850	64.13%	35.87%
Highlands	411,568	567,174	978,742	42.05%	57.95%
Amazon	29,106	101,422	130,528	22.30%	77.70%
Total	1,027,299	997,953	2,025,252	50.72%	49.28%

Source: INEC 2001.

Table 3-3. Distribution of the microcredit portfolio by province for regulated microfinance institutions in Ecuador, 2005–2009

Province	Dec. 2005	Dec. 2006	Dec. 2007	Dec. 2008	Jun. 2009
Pichincha	31.00%	40.42%	42.94%	28.91%	26.07%
Guayas	16.96%	11.73%	11.11%	12.75%	13.44%
Tungurahua	11.17%	9.63%	8.21%	8.81%	8.80%
Manabí	4.83%	4.13%	4.31%	6.53%	6.82%
Azuay	5.24%	5.89%	5.87%	5.76%	6.03%
Imbabura	7.58%	6.54%	5.63%	5.99%	6.03%
Chimborazo	5.00%	4.48%	4.60%	5.67%	5.89%
Cotopaxi	5.28%	4.88%	4.45%	4.74%	5.13%
Loja	4.27%	4.52%	4.61%	3.58%	3.45%
Santo Domingo de Los Tsáchilas	-	-	-	3.01%	3.03%
Carchi	2.59%	2.27%	1.96%	2.54%	2.75%
El Oro	1.36%	1.18%	1.17%	2.51%	2.70%
Los Rios	0.72%	0.56%	0.74%	1.74%	2.01%
Bolivar	1.11%	1.04%	1.27%	1.65%	1.67%
Esmeraldas	0.54%	0.40%	0.53%	1.42%	1.44%
Pastaza	1.34%	1.15%	1.07%	1.17%	1.19%
Santa Elena	-	-	-	0.80%	0.84%
Cañar	0.32%	0.32%	0.53%	0.68%	0.74%
Sucumbíos	0.16%	0.17%	0.18%	0.43%	0.47%
Morona Santiago	0.10%	0.02%	0.10%	0.39%	0.46%
Zamora Chinchipe	0.08%	0.45%	0.46%	0.32%	0.36%
Napo	0.27%	0.16%	0.16%	0.33%	0.36%
Orellana	0.06%	0.04%	0.07%	0.25%	0.31%
Galapagos	0.03%	0.02%	0.02%	0.01%	0.02%

Source: SBS 2009.

Table 3-4. Distribution of lending methodologies for 44 institutions in the Red Financiera Rural, June 2010

	Private bank		Credit union		NGO		Total	
Methodology	Loan portfolio ($)	Share of total	Loan portfolio ($)	Share of total	Loan portfolio ($)	Share of total	Loan portfolio ($)	Share of Total
Individual	734,056,086	97.24%	485,406,639	94.98%	49,797,763	57.25%	1,269,260,488	93.81%
Solidarity group	1,966,464	0.26%	19,631,426	3.84%	10,609,540	12.20%	32,207,430	2.38%
Village bank	18,871,198	2.50%	5,173,655	1.01%	26,189,314	30.11%	50,234,168	3.71%
Associative	-	-	859,341	0.17%	113,338	0.13%	972,679	0.07%
Second-tier	-	-	-	-	276,197	0.32%	276,197	0.02%
Total	754,893,749		511,071,062		86,986,151		1,352,950,961	

Source: RFR 2010b.

CHAPTER 4
DEPTH OF OUTREACH

Microfinance was originally conceived as a tool for poverty alleviation, but it does not always reach the poorest of the poor. This chapter examines the major issues involved in the provision of microfinance services for poor individuals and women in Ecuador. I first examine the socioeconomic characteristics of Ecuadorian microfinance clients. It is important to examine how supply-side and demand-side factors contribute to the relatively low concentration of poor microentrepreneurs at Ecuadorian MFIs. I also analyze the distribution of credit among all socioeconomic sectors, especially across different institutional forms.

Women have also become a popular target of microfinance programs around the world for a number of reasons. Microfinance has a tradition of targeting women since women tend to suffer a higher degree of economic marginality than men. Household constraints limit women's ability to seek outside employment, so women often gravitate toward microenterprises as a means of supporting the household. I examine why the global microfinance movement has taken up the mission of serving women and the extent to which this trend is applicable to the Ecuadorian case.

Poverty Outreach

The 1997 Microcredit Summit in Washington D.C. established the importance of microcredit as a means of fighting poverty and highlighted the need for a wide variety of providers in order to expand access to credit among poor individuals and women (Jordán Bucheli and Román Ferrand 2004). Microfinance has also become a major element in achieving the Millennium Development Goals (CGAP 2003).[1] Ultimately, poverty alleviation is not a

[1] The Millennium Development Goals are the following: 1) eradicate extreme poverty and hunger; 2) achieve universal primary education; 3) promote gender equality and empower women; 4) reduce child mortality; 5)

consensus goal for all microfinance programs, and the socioeconomic characteristics of microfinance clients vary widely across different institutions.

Exclusive targeting of the poor may not be necessary in order to have a real impact on poverty (González Aguilar 1999; Robinson 2001). According to this view, it is better to build competitive, sustainable financial systems that provide a wide range of products and services that respond to the multidimensional needs of the poor. It is common to find larger institutions that cross-subsidize their clientele—serving both higher- and lower-income microentrepreneurs—which allows the institution to generate more capital and operate sustainably.

The following data analysis centers on the socioeconomic status of clients in the Ecuadorian microfinance sector. In the 2004 survey by the USAID, socioeconomic status was calculated from 10 variables that assess an individual's access to basic services: sanitary water supply, sewage, restrooms, electricity, shower, telephone, literacy, years of school, hospital medics per 1,000 inhabitants, and hospital beds per 1,000 inhabitants (INEC 2011). Seven variables relate to basic household services, and the remainder pertains to levels of education and healthcare. These variables are used to determine an individual's living conditions index (ICV). This figure reflects the percentage of a person's basic needs that are currently unsatisfied. In other words, a high ICV corresponds to a high proportion of unmet basic needs and, therefore, lower socioeconomic status. In 2006, an ICV of 45.74% was the average figure for the country's poor population (Castillo 2009: 55). The quintiles correspond to the following unmet basic needs indicators: q1 = 35.46–74.74; q2 = 27.34–35.46; q3 = 21.52–27.34; q4 = 16.27–21.52; q5 = 0–16.27. By these measurements, only 6.64% of the USAID survey respondents fall below the poverty line, which corresponds to an ICV of 45.74%.

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improve maternal health; 6) combat HIV/AIDS, malaria and other diseases; 7) ensure environmental sustainability; and 8) develop a global partnership for development.

The primary indicator often used to assess the depth of outreach is average loan size. Data from the 2004 USAID survey reveal a statistically significant correlation ($p<.01$) between average loan amounts and socioeconomic status (Table 4-1). The poorest quintile holds average loans of $917, compared with $2,791 for the wealthiest. Despite the positive correlation, average loan size is an increasingly questionable measure of socioeconomic status, since the array of loan products offered by MFIs is continually expanding (Berger et al. 2006). Such products may include loans for short-term working capital, long-term fixed assets, consumer credit, housing, home improvement, and small business expenditures. The alternative uses of these products make it difficult to analyze average loan amounts as a proxy for client wealth.

There is little evidence of outright discrimination against poor microentrepreneurs at Ecuadorian MFIs. Microentrepreneurs of lower socioeconomic status are no more likely to have their credit applications rejected or to receive lower amounts than requested. On average, the poorest quintile requests $1,129 and receives $1,099, while the wealthiest quintile requests $3,797 and receives $3,179. Table 4-2 shows that requests for loans are almost always granted, regardless of a client's socioeconomic status. Overall, at a statistically significant level of .01, 16.7% of all respondents requested a loan in the last 12 months, and 16.6% received a loan. Among the 8.4% of microentrepreneurs from the poorest quintile that requested a loan, 8.4% received a loan; among the 24.7% of microentrepreneurs from the wealthiest quintile that requested a loan, 24.5% received a loan. Nonetheless, these figures may reveal a selectivity bias. The proportion of poorer microentrepreneurs requesting credit (8.4%) is substantially lower than the number of wealthier microentrepreneurs requesting credit (24.7%). This suggests that the poorest segments perceive less of a potential benefit from credit. It may also be the case that capital-poor microenterprises do not have the ability to pay off a high-interest loan.

Are the poor being excluded from institutional credit, or do they have less demand for it? Institutions often promote their services door-to-door, so there may be some selectivity bias in terms of which communities that they target. According to the 2004 USAID survey, the poorest quintile of respondents is less likely to have applied for a loan in the last 12 months—only 8.4% compared with 24.7% of the wealthiest quintile. One can begin to understand this divide by examining why non-borrowers are compelled to stay out of the market (Table 4-3). A number of reasons are fairly constant across different socioeconomic levels, but others reveal some distinct trends. In terms of the demand for credit, only 7.7% of the poorest quintile expressed no interest or need for credit, compared with 17.7% of the wealthiest quintile. Smaller businesses may have a greater need for credit since they have less capital and cannot realize economies from bulk purchases without a loan (Liedholm 1992, 272). The poorest quintile expressed more concern about not meeting requirements (13.7%) than the wealthiest segment (5.4%). The poorest quintile was also more likely to report that they did not know where to apply for credit—4.6% compared to 1.5% of the wealthiest quintile. Interestingly enough, high interest rates were a principal deterrent for only 10.1% of the poorest segment, compared to 14.5% of the wealthiest segment. This likely derives from the greater need for capital investment among the poor, as well as a lack of other options in the market. The poorest individuals likely anticipate paying higher interest rates to informal lenders, making institutional credit seem more appealing by comparison (Collins et al. 2009).

There is a marked segregation of clients by socioeconomic status across different types of institutions (Table 4-4). According to the 2004 USAID survey, private banks and credit unions have a wealthier client base than NGOs. The wealthiest quintile represents 36.3% of clients at private banks, while the poorest quintile represents 7.3% of clients. At credit unions, the

wealthiest quintile represents 32.9% of clients, while the poorest quintile represents 5.8% of clients. NGOs, on the other hand, have a more equitable distribution of clients, but they tend to be more concentrated in the lower socioeconomic quintiles. About 24% of clients at NGOs belong to the poorest quintile, while 16% of clients belong to the wealthiest quintile. These figures confirm that NGOs are generally more likely to have a greater depth of outreach. This is hardly surprising, given that equity for banks and credit unions is generally derived from gain-seeking private investors. Since funding for NGOs often comes from sources that are oriented toward poverty-alleviation goals in developing countries, they remain constrained into serving lower socioeconomic sectors.

Some researchers suggest that the type of lending methodology employed may reflect the socioeconomic reach of microfinance (Westley 2004). In general, there is a significant correlation between lending methodologies and their corresponding median loan amounts. In 2008, median loan balances at 1,084 global institutions were $152 for village banking clients, $111 for solidarity group loans, and $1,404 for individual loans (MIX Market 2009). Group lending may lower the average cost per individual client, which allows institutions to disburse lower average loan amounts. It should also be noted that Ecuadorian NGOs dedicate more of their operations to group lending than private banks and credit unions.

Minimum Requirements

Credit unions almost always have a minimum savings requirement, known as *encaje*—a requirement that borrowers save an amount of money corresponding to a certain percentage of the loan amount. The required savings amount varies by institution, but 10% of the loan amount is a commonly cited figure. This savings balance acts as a form of collateral and also buttresses the equity structure of the institution.

Following the 2008 economic crisis, many institutions began to require more strict collateral requirements. In December 2008, 94% of clients held solidarity guarantees, but this figure fell to 75% by December 2009 (RFR 2009, 134). The financial sector as a whole did not grow very much during that time, with its total portfolio growing at less than 0.2% (Table 4-5). When arrearage increases, institutions appear more likely to demand greater requirements from clients. At the credit union Artesanos, the institution recorded an arrearage rate of 12.2% in 2009, but they managed to reduce this to 5.4% by mid-2010. The reduction was induced by demanding better credit scores and more thorough analyses of applicants (Carrasco 2010).

In Ecuador, MFIs typically require that microentrepreneurs have between six months and two years of experience in running a business before receiving a loan. During the evaluation process, it must be demonstrated that the business is generating enough cash flows to pay off a loan. Javier Vaca, the Executive Director of the RFR, notes,

> As a requirement, it has been accepted by the majority of institutions that in order for a microentrepreneur to be able to access a loan, he/she needs to have two years of experience in some activity, not just as a standard requirement but also because studies have shown that two years is the time needed to establish a functioning microenterprise. Out of every 10 new enterprises, about 3 or 4 always fail, and there are microentrepreneurs that manage to get going on their second or third attempt. So, if one finances new businesses, it would represent a risk to the institution between 30 and 40% of their capital. So it cannot be done. From there, one can look at other kinds of projects like civil capital or collaborative projects, for start-up businesses that are donor-funded, through credit… There are NGOs that have a start-up fund, a risk fund, funds for supporting start-ups, for assisting young people; there are many. But those work with donor funds, where you know that for every 100 that you give out, you have a risk of losing between 20 and 30 (Vaca 2010).

The minimum experience requirement effectively excludes individuals that do not have an established business. As a result, start-up capital comes predominantly from personal savings. Capital-starved businesses are less likely to reach a point at which institutional credit would be attainable.

Credit unions usually require a minimum savings balance for each loan, a requirement known as *encaje*. This requirement prohibits access to credit for those who lack savings, and it increases the effective interest rate charged by the institution. The savings balance is often conceded to cancel the final payment, but the interest expense is still calculated upon the principal amount. This raises the effective rate of the loan. By law, the implicit cost is included in the stated interest rate, so clients will not pay a higher interest rate than advertised.

There is another scenario in which certain institutions will include a minimum savings balance as part of the loan, assuming that the client lacks savings. This is the case at the credit union Artesanos. Ultimately, the client is responsible for paying off the savings balance and any interest that accrues on that sum, so the effective interest rate is even higher than under normal circumstances.

Outreach to Women

In many ways, women are ideal targets for microfinance programs that are concerned with economic and social development. First, women tend to be concentrated in more vulnerable economic sectors like commerce, placing them at a disadvantage in accessing credit at formal financial institutions (Powers and Magnoni 2010; United Nations 2009). Second, studies indicate that female clients are more preoccupied with household welfare, since women often pay for healthcare and children's education (Pitt and Khandker 1998). Historically, women have struggled to gain access to institutional credit. Ecuadorian women in rural and marginal urban areas still face a number of obstacles in obtaining credit: higher geographic dispersion, social marginalization, low self-esteem, limited business experience, and difficulty in meeting minimum requirements (Jordán Bucheli and Román Ferrand 2004, 114).

Many proponents of women's empowerment through microfinance argue that access to credit represents an initial step to other forms of economic, social, and political empowerment.

Mahmud (2003) found that female participation in Bangladeshi microfinance programs led to improvements in intra-household decision-making power, time allocation, and fertility regulation. Female participants in poor households were more likely to be active in decisions concerning food consumption expenditures and children's education. Participants in non-poor households were more likely to exercise control in decisions about crop production. However, participation did not contribute to resource accumulation, so microcredit did not broaden access to healthcare. In a survey of nearly 1,800 households in Bangladesh, Pitt and Khandker (1998) found that credit provided to women positively influenced their decision-making power on household expenditures, women's ownership of non-land assets, the supply of male and female labor, and schooling for boys and girls. On the other hand, credit provided to men only produced a significantly positive effect on boys' schooling. Pitt et al. (2003) argue that access to credit may bring about improvements in household welfare and bargaining power, but they also note that access to credit among men can undo many of those gains.

The empowerment of women is often discussed within the context of group lending. Group dynamics may encourage the development of leadership skills and greater organizational participation on the part of women (Montesdeoca and Cordero Ramos 2009). Maldonado Alarcón (2007, 11) found that women's participation in Ecuadorian community bank programs (*cajas comunales*) helped the participants in lowering transaction costs, obtaining timely and continual credit, developing a culture of savings and financial management, developing management skills, and strengthening community relations.

Group lending schemes may also generate social networks. As argued by Molyneux (2002, 175), social capital is "generally seen to operate as a collective good, with beneficial outcomes, as a policy resource that must be operationalized and if possible strengthened by its association

with development projects and goals." Nonetheless, there are differing interpretations about the effectiveness of microfinance in fomenting social capital. For example, a case study in rural Bolivia concluded that community solidarity and reciprocity had diminished competitiveness among businesses (Maclean 2010). As a result, borrowers were unable to generate sufficient revenue, so they relied upon informal loans from the community in order to repay their loans.

Microfinance has been criticized for perpetuating economic discrimination against women, particularly because savings and credit do little to promote alternative economic activities. A study from Quito found that microcredit generally sustains extant economic activities but fails to create jobs that employ other women (Buvinic et al. 1989). Furthermore, indebtedness can become a burden for economically vulnerable women. Feiner and Barker (2006) argue that credit creates a dual burden of economic and household responsibilities for women who may not be capable of shouldering those roles.

Constraints on Women's Microenterprises

Women control a substantial number of micro- and small enterprises in Ecuador. As of 2009, women represented 41% of Ecuador's economically active population and 57% of the country's microentrepreneurs (Castillo Añazco 2009, 51). Many women microentrepreneurs are single heads of household, indicating that microenterprises may constitute a major safety net for women (USAID 2005, XVIII).

Ecuadorian men and women often provide different reasons for starting a new enterprise. In 2006, many female microentrepreneurs reported that they opened a business in order to complement family income (57%) or to become independent (24%) (Castillo Añazco 2009). The major reasons for men to open a business were the desire to be independent (45%), to complement family income (21%), and the failure to find salaried work (17%). Men tend to establish businesses because of the attractiveness, or the necessity, of self-employment.

According the 2004 USAID survey, about 59% of women microentrepreneurs work within the home, compared to 37% of men (Table 4-6). The difference most likely derives from social norms and the demand for reproductive labor in the household. Men were almost twice as likely to work as street vendors or to have no fixed business location.

Women's microenterprises largely operate informally. According to the 2004 USAID survey, about 10% of female-controlled microenterprises are affiliated with the Instituto Ecuatoriano de Seguridad Social (IESS), compared with 18% of male-controlled microenterprises. About 22% of female-controlled microenterprises have a tax ID number, compared with 32% of male-controlled enterprises (USAID 2005). This high degree of informality indicates that many female-controlled businesses operate at a very small-scale and may be susceptible to exclusion from financial markets and economic resources.

Employment patterns among microenterprises demonstrate some gendered characteristics. Men tend to hire male employees, and women tend to hire female employees (USAID 2005, XVIII–XIX). This derives largely from the nature of the business and the required skills. Men's microenterprises tend to be larger and hire more employees. Women often work in the home and have fewer opportunities to acquire new skills.

Women's microenterprises tend to generate comparable profit margins and less sales revenue than men's microenterprises (Table 4-7). Profit margins—defined as weekly income divided by weekly sales—are approximately 48.0% for men and 45.5% for women. However, women generate nearly half as much annual sales as male microentrepreneurs. Men averaged $12,255 in annual sales overall, compared with $6,489 for women. About 65% of female microentrepreneurs are concentrated in the commerce sector, where men generate almost double the sales revenue generated by women. Commerce activities have fewer barriers to entry in terms

of education, technology, and capital requirements. The production sector employs about 15% of female and 21% of male microentrepreneurs, with men generating three times more annual sales revenue than women.

According to the 2004 USAID survey, male microentrepreneurs in Ecuador provide a greater proportion of overall household income than women. Nearly 57% of men and 26% of women reported being the sole contributors to family income (USAID 2004). About 11% of men and 35% of women reported that their microenterprises contributed "less than half" or "very little, almost nothing" to family income. Overall, one can deduce that men make a greater contribution to family income, but they may not contribute a greater share of their individual incomes.

Women's Access to Microfinance

The incorporation of women in microfinance programs entails a substantial effort on the part of the institution, as noted by Janeth Palacios, the General Director of the credit union Mujeres Unidas:

> There is a split between men and women, poor and rich in access to credit in the financial system… There needs to be a greater effort to reach out to these groups, to women, to the rural sector, but it is not easy because finances cannot work in isolation. Working with these groups requires training and all that that requires. In our case, 60% of our *socias* do not have a primary education. Around 20% are still illiterate… Here we have to make a strong effort to accompany the client throughout the credit process, to obtain their credit profile, to track the loan… everything (Palacios 2010).

Despite these challenges, numerous MFIs around the world cite benefits of targeting women, particularly with respect to their higher rates of repayment relative to men (Yunus 2003). Armendáriz and Roome (2008) argue that repayment rates are higher among women because they are more risk averse and conservative in their investment patterns. Also, moral hazard is lower with women because they often have less access to other sources of financing.

Some argue that women behave more cooperatively in groups than their male counterparts (Anthony and Horne 2003). There are no clear indications that women are better payers than men in Ecuador, since there are currently no individual-level data concerning default rates by gender. Institutional-level data from the RFR indicate that MFIs featuring the highest concentrations of women are no more likely to have lower default rates than MFIs with the lowest concentrations of women. The evidence from Asia may not be easily applicable to the Ecuadorian context, particularly since Grameen-style group methodologies are less utilized. This removes the importance of group pressures on women compared with men. For example, about 73% of clients are women at the credit union Mujeres Unidas. The institution has a relatively low amount of overdue credit—about 1.84% of the total portfolio. Janeth Palacios, the General Director of the credit union, argues that gender is not the determining factor in contributing to such a low arrearage rate. On this issue, she argues that the institution benefits from working with local women's organizations:

> First, I believe that working with local organizations helps a lot because the organization takes charge in trying to perfect itself. When they come, there are two credit solicitations, one from the organization and a list of the individuals that want credit. Later, there is the individual analysis. There is an analysis of the organization and an analysis of the individual. That is one important aspect. The other aspect is the credit methodology employed. We work to analyze the nature of the project, and we look at the market situation… If we have a lower default rate, that is probably because we work more with agricultural activities (Palacios 2010).

Some Ecuadorian MFIs have explicit policies for the recruitment of female clients. These policies may stem from the demands of the lending methodologies or the leadership of the institution. Javier Vaca (2010), Executive Director of the RFR, notes,

> Some institutions demand women clients, like in the village bank, which is a participatory process. If you look at the bank FINCA, a major part of its clients are women but that is due to its methodology and because it requires a lot of time. But there are other NGOs, on the other hand, where the donor requires that at least 50% of the clients be women. They emphasize giving credit only to women… If you see

> that an NGO has more female clients than banks, in the long-run it is because of product impositions where you demand that the woman sign for the loan.

MFIs in Ecuador and Latin America often do not have specific policies for targeting female clients. Women represent only about 38% of clients in Latin America, compared with over 60% of clients in Africa and Asia (Berger 2006, 15). Data from the 2004 USAID survey indicate that women represent nearly half of all clients at Ecuadorian MFIs (Table 4-8).[2] Public banks have the lowest concentration of female clients (36%), followed by private banks (42%). Credit unions have a slightly larger female client base (47%). Many large credit unions also serve small- or medium-sized enterprises, which tend to be male-dominated. The credit union may promote its services toward women, but the operative idea is that anyone can open a savings account and request a loan (Palacios 2010). NGOs have the highest concentration of women (75%), since many NGOs have explicit policies for targeting women.

Women may be coerced into taking out debt. According to Javier Vaca, the Executive Director of the RFR, it is not uncommon that women are coerced by their husbands or other male members of the household into requesting a loan:

> In practice, if you do not have an integral gender policy, we see that many times women get used. You, as a woman, get the loan but afterward it will be given to the husband who administers the loan. So, if you focus only on statistics, then yes, you have women clients but you will need to see if these women are really the ones that control the loans or the ones that are only liable for them… It is easy for the family to say, "Let the women go get the loan." So I would say that the proportion of women [clients at MFIs] is not a real indicator (Vaca 2010).

In spite of this potential manipulation, Greeley (2005) argues that channeling loans through women may provide women a stronger voice in the household.

[2] Nonetheless, a study on microfinance outreach in Quito, Guayaquil, and Cuenca indicates that 70% of individuals who utilized financial services—including both microfinance and non-microfinance services—in 2003 were men (Jácome 2005: 6).

It is possible that male manipulation could increase when MFIs exclusively target women, particularly in isolated communities with few alternative sources of financing. The credit union Mujeres Unidas has gradually attracted more male clients, many of whom are related to the institution's female clients. According to Janeth Palacios, the General Director of Mujeres Unidas, the institution arrived at this decision after considering the potential impact of the inclusion of males on household welfare:

> We decided to split from targeting only women in order to support the family too… We have gone down to 63%, 64% women because of the incorporation of the family… There is also another matter, which is that conjugal credit products have higher loan amounts. It is difficult for only one person to assume that amount. Sometimes the loans are for larger businesses… That is, a family business controlled by the woman and her spouse. It gets divided in two… The important thing is to not decline in the percentage of women and to try to regain the percentages that we have maintained in the past (Palacios 2010).

The decline in the proportion of female clients at MFIs is often construed as evidence of mission drift. Mujeres Unidas does not fit well into this category, since its incorporation of male clients occurs mostly through its female clients. This policy may mitigate the degree to which women are used as conduits for obtaining credit, since men will have an opportunity to gain access to credit in their own right.

The representation of women in institutional leadership roles can be consequential in fomenting gender-inclusive policies in MFIs. Javier Vaca (2010) of the RFR notes, "We have seen data in which credit unions that have a female manager or a female president have better indicators [on the incorporation of women]… Those that feature women in higher levels of power influence the global administration of the institution." Global studies show that women tend to be scarce in leadership positions at major financial institutions (United Nations 2009). In interviews with eight microfinance institutions, the ones that expressed an explicit concern over

the inclusion of women all had female executives: CEPESIU, Casa Campesina de Cayambe, and Mujeres Unidas.

It is difficult to measure the extent to which women are excluded from Ecuadorian MFIs. An econometric study by Guachamín Andrade (2010) suggests that women are subject to discrimination with respect to the loan amounts provided. Regression analysis on credit applications suggests that about $4 out of every $100 lent is a product of discrimination. While it is true that women typically receive smaller loan amounts than men, it is possible that this could arise, at least partially, from other limitations. Studies indicate that women are relatively more cautious about indebtedness, often taking out smaller amounts with shorter payment periods. Data from 2004 indicate that women request $1,969 from MFIs, while men request $3,684 (Table 4-9). Smaller loan amounts may also be reflective of the greater degree of women's poverty and the inability of their businesses to absorb capital, given their concentration in industries with few barriers to entry and low capital requirements (Buvinic et al. 1989; Cheston and Kuhn 2002). Women also tend to have less experience in running their current business. Women's enterprises averaged 8.04 years of existence, compared with 12.18 years for men's enterprises (USAID 2004). This volatility may mean that women are less likely than men to have the requisite experience demanded at major institutions.

Finally, there is the issue of the commercialization of microfinance and the effect that it has on outreach to women. The commercialization of microfinance refers to the application of market principles and a greater focus on financial sustainability. Regulated institutions need to operate at a larger scale in order to absorb the costs and constraints of regulation, particularly the requirements that they maintain minimum capital balances and liquidity ratios. Institutions that aspire to achieve formal status are therefore required to target higher-income clients that will

allow them to grow. This often results in a decline in female clients. A global study found that commercialization led to a drop in women clients from 88% to 60% over a period of five years (Frank 2008, 13).

Institutions have also adapted their policies to accommodate recent downturns in the economy. In 2010, CEPESIU increased the number of individual loans in an effort to maintain a stronger portfolio. Since 1992, ESPOIR has exclusively targeted female clients with mostly village banking methodologies. However, in the last two years they have revised their policies in an effort to protect the institution's loan portfolio from economic and political instability (Fundación ESPOIR 2008). They now have an individual loan product, which can be offered to a maximum of 20% men.

Discussion

Depth of outreach refers to the degree of incorporation of economically vulnerable individuals, namely women and the poor. Clear patterns emerge when analyzing the depth of outreach by institutional form. NGOs incorporate more women and people of lower socioeconomic status relative to banks and credit unions. Banks usually serve a broad clientele base, cross-subsidizing large credit operations with small ones. Credit unions typically serve local markets and often extend financing to small- and medium-size enterprises.

Women and poor microentrepreneurs typically demand credit in smaller quantities. The poorest segments of microentrepreneurs were less likely to request a loan because of the difficulty of meeting institutional requirements. Women generally take out smaller loan amounts with shorter payment periods, but they take on a slightly higher number of loans than men. Women often become microentrepreneurs as a means of supplementing family income and being able to accommodate domestic labor obligations.

Microfinance is often viewed as a positive source of empowerment for women. A number of global studies on female microfinance clients argue that access to credit can improve the position of women in the household. Around the world, women have a reputation for achieving higher repayment rates than men, but there are no data from Ecuador to confirm this phenomenon. In the Ecuadorian case, women's leadership in MFIs may have a beneficial effect on the incorporation of female clients. Women also tend to be concentrated in institutions that utilize group lending methodologies.

Many of the constraints facing microfinance clients derive from a lack of access to business development services. Credit policies are constructed such that experienced microentrepreneurs must prove their ability to generate a profit, effectively excluding individuals who lack enough start-up capital to initiate a business. Without analyzing the root causes of economic marginality, microfinance will only amount to a means of sustaining current economic activities rather than promoting viable alternatives for poor individuals and women in the long term.

Table 4-1. Average credit amounts requested and received by the socioeconomic status of Ecuadorian microentrepreneurs, 2004

	Poorest (q1)	(q2)	(q3)	(q4)	Wealthiest (q5)	Total
Average total credit requested	$1,129	$1,872	$2,537	$3,248	$3,797	$2,852
Average total credit received	$1,099	$1,617	$2,195	$2,673	$3,179	$2,408
Average loan amount	$917	$1,407	$1,869	$2,370	$2,791	$2,101

Notes: p<.01. Source: Calculated from USAID 2004.

Table 4-2. Percentage of Ecuadorian microentrepreneurs requesting and receiving loans by socioeconomic status, 2004

	Poorest (q1)	(q2)	(q3)	(q4)	Wealthiest (q5)	Total
Requested a loan in the last 12 months	8.4%	11.5%	17.5%	21.4%	24.7%	16.7%
Received a loan in the last 12 months	8.4%	11.6%	17.4%	21.3%	24.5%	16.6%

Notes: p<.01. Source: Calculated from USAID 2004.

Table 4-3. Reasons that Ecuadorian microentrepreneurs did not seek credit by socioeconomic status, 2004

Reason for not seeking credit	Poorest (q1)	(q2)	(q3)	(q4)	Wealthiest (q5)	Total
Don't want to be indebted	30.4%	29.7%	31.8%	30.9%	31.5%	30.8%
Procedures are difficult	16.9%	17.3%	18.4%	17.4%	15.8%	17.2%
Interest rates too high	10.1%	12.1%	11.9%	13.1%	14.5%	12.2%
Not interested, no need	7.7%	9.3%	12.0%	14.1%	17.7%	11.8%
Don't meet requirements	13.7%	11.4%	8.8%	7.3%	5.4%	9.6%
Lack of collateral	8.9%	9.6%	7.5%	7.3%	5.2%	7.8%
Don't know where to apply	4.6%	3.0%	2.3%	2.1%	1.5%	2.8%
Don't want to lose Bono Solidario	2.2%	1.7%	1.1%	0.4%	0.3%	1.2%
Other	5.6%	6.0%	6.1%	7.5%	8.1%	6.6%

Notes: p<.01. Source: Calculated from USAID 2004.

Table 4-4. Distribution of the socioeconomic status of Ecuadorian microentrepreneurs across institutional form, 2004

Socioeconomic status (quintile)		Public banks	Private banks	Credit unions	NGOS & foundations	Other	Total
Poorest	(q1)	5.6%	7.3%	5.8%	24.0%	8.1%	10.1%
	(q2)	12.3%	11.4%	12.1%	20.1%	15.2%	13.8%
	(q3)	21.8%	19.3%	22.5%	20.7%	21.8%	21.0%
	(q4)	26.8%	25.7%	26.7%	19.2%	26.5%	24.9%
Wealthiest	(q5)	33.5%	36.3%	32.9%	16.1%	28.3%	30.2%

Notes: p<.01. Source: Calculated from USAID 2004.

Table 4-5. Distribution and growth of loan portfolios for 99 regulated and unregulated financial institutions in Ecuador (in millions of dollars), 2006–2009

Institution	Variables	2006	2007	2008	2009
Banks	Portfolio	$6,789.54	$7,570.74	$9,583.15	$9,453.00
	Share of total	89.39%	86.98%	87.12%	85.79%
	Rate of growth	24.90%	11.51%	26.58%	-1.36%
Credit unions	Portfolio	$783.22	$1,093.08	$1,349.39	$1,493.50
	Share of total	10.31%	12.56%	12.27%	13.55%
	Rate of growth	22.10%	39.56%	23.45%	10.68%
NGOS	Portfolio	$22.30	$40.22	$67.92	$72.69
	Share of total	0.29%	0.46%	0.62%	0.66%
	Rate of growth	6.50%	80.36%	68.87%	7.02%
Total	Portfolio	$7,595.06	$8,704.04	$11,000.46	$11,019.19
	Rate of growth	-	14.60%	26.38%	0.17%

Source: RFR 2009.

Table 4-6. Location of the business for Ecuadorian microentrepreneurs by gender, 2004

Location of the business	Men	Women	Total
At home	15.8%	32.3%	23.6%
At home, in dedicated location	20.8%	26.4%	23.4%
Street vendor	11.5%	5.9%	8.8%
Transitory stall on street/market	7.7%	8.1%	7.9%
Permanent market stall	3.6%	4.4%	4.0%
Permanent store, shop, workshop	14.9%	9.3%	12.3%
No fixed location	25.8%	13.7%	20.1%

Notes: p<.01. Source: Calculated from USAID 2004.

Table 4-7. Annual sales and profitability ratios of Ecuadorian microenterprises, 2004

Economic sector	Annual sales or profitability	Men	Women	Total
Services	Annual sales	$8,527	$6,166	$7,431
	Profitability	53.4%	50.0%	51.8%
Production	Annual sales	$11,146	$3,423	$8,268
	Profitability	50.4%	56.9%	52.8%
Commerce	Annual sales	$15,759	$7,226	$11,005
	Profitability	40.3%	41.6%	41.0%
Total	Annual sales	$12,255	$6,489	$9,587
	Profitability	48.0%	45.5%	46.8%

Notes: p<.01. Profitability = (weekly income) / (weekly sales revenue). Source: Calculated from USAID 2004.

Table 4-8. Distribution of the gender of Ecuadorian clients at microfinance institutions, 2004

Gender	Public banks	Private banks	Credit unions	NGOS & foundations	Other	Total
Men	64.2%	57.8%	53.4%	30.7%	52.5%	50.8%
Women	35.8%	42.2%	46.6%	69.3%	47.5%	49.2%

Notes: p<.01. Source: Calculated from USAID 2004.

Table 4-9. Measures of indebtedness among Ecuadorian microentrepreneurs, 2004

Measure of indebtedness	Men	Women	Total
Requested a loan in last 12 months	16.10%	17.30%	16.70%
Average number of loans	1.18	1.22	1.20
Average loan term (months)	10.94	7.54	9.12
Total credit requested	$3,684.00	$1,969.00	$2,852.00
Total credit received	$2,960.00	$1,829.00	$2,408.00

Source: Calculated from USAID 2004.

CHAPTER 5
GROWTH AND SUSTAINABILITY

Sustainability is a vital challenge confronting all MFIs. Currently, the global industry is transitioning from a more subsidized model of microfinance to an emphasis on fostering sustainable financial systems, a transition that has made microfinance increasingly profitable and competitive (United Nations 2009). Sustainability considers not only the cost of microcredit operations but also the constraints that are externally imposed, such as those arising from competition and government regulation. Operational and environmental constraints affect outreach in a significant way, inducing MFIs to determine which market segments are feasible to serve.

Beyond mere sustainability, many institutions have become preoccupied with growth. As demonstrated by a number of Ecuadorian MFIs, institutions often expand beyond their traditional market niches as they grow. Growth often involves some form of cross-subsidization, in which larger loans offset the lower profitability of smaller loans. The incentive to move upmarket raises concerns about mission drift (i.e., the tendency for MFIs to regress from their original social objectives). This chapter explores a central question in microfinance: can institutions grow while serving the poor, or must they abandon the poor in order to grow?

Poverty Lending and Financial Systems Approaches

The Ecuadorian microfinance sector grew during a time when many institutions around the world were transitioning from a donor-based model of microfinance to one of sustainability (Robinson 2001). The previous “poverty lending” approach is donor-subsidized and linked with other support services. The “financial systems” approach is targeted at the “bankable poor,” claiming that the poorest individuals are better served through subsidized job creation and social assistance (United Nations 2009, 57). Institutions now face a dual maximization problem in

attempting to reach the poor while remaining sustainable entities (Rhyne 1998). This dilemma is known as the "double bottom line," since MFIs are expected to satisfy both social and financial objectives (Frank 2008).

In recent years, subsidization has been criticized as a long-term solution for microfinance. Armendáriz and Morduch (2010) argue that subsidies may be most effective when applied to institutional start-up costs, ultimately leading to improvements in efficiency and repayment rates. However, subsidies can slow the rate of innovation and fail to generate long-term improvements when they expire. Furthermore, subsidies may encourage commercial banks to incorporate existing MFI clients rather than expand outreach to new segments (Johnson 2005).

MFIs that rely on subsidized funding are also vulnerable to the evolving priorities and support levels of donors, a phenomenon known as "donor fatigue." NGOs that offer business development services and work with poor sectors are particularly susceptible to this phenomenon. For example, CEPESIU and Casa Campesina de Cayambe have experienced fluctuations in their loan portfolios and the number of active clients due to the availability of external funding in recent years. From 2002 to 2009, Casa Campesina had three years where the total portfolio was less than the previous year and four years in which the number of clients decreased (MIX Market 2011b). Even though the 2008 global economic crisis did not have a structural impact on the Ecuadorian microfinance sector, traditional sources of funding from Europe and the United States diminished to a certain degree (Vinueza 2010).

This is not to say that NGOs are mired in an antiquated model of microfinance. While Ecuador's microfinance NGOs are exposed to fluctuations in external funding, they often have higher growth rates than private banks in terms of loan portfolios and clients. Some organizations use a project financing approach, working on projects geared toward employment

and business development, such as CEPESIU (CGAP 2001, 14). These programs tend to have lower growth rates. There is also the portfolio approach, which involves large-scale financial intermediation (La Torre 2006). Guayaquil's D-Miro, which recently upgraded to private bank status, exemplifies this type of approach.

The general shift from subsidized delivery to healthy financial systems has changed the dynamics of microfinance over the last two decades. Subsidized funding was too limited to fuel a global industry, so MFIs grew into larger, unsubsidized providers. Large-scale providers can cover regulatory costs more easily, offer more services and savings products, and use physical and institutional infrastructure to increase outreach in a more policy-conducive environment (Johnson 2005). The shift toward sustainability has engendered a new concern for institutions, namely how to turn a costly practice into a mainstream part of the financial system. MFIs now confront the challenges faced by commercial lenders: increasing competition, the need for commercial investment, technological change, and government regulation (Hermes et al. 2008).

Sustainability and outreach are not diametrically opposed (Woller 2002). In fact, serving the poor can be more profitable than serving higher-income sectors (Table 5-1). In a 2002 study of 56 MFIs in Latin America, medium-sized MFIs that target low-income sectors had the highest value for operational self-sufficiency (136.7%) and the highest adjusted profit margin (22.1%) (MIX Market 2002).[1] This category of institutions also had a very small average loan amount ($239) and a high percentage of women borrowers (83.6%). The larger institutions tend to have broader target groups—characterized by both upper- and lower-income clients—which may bring them into competition with commercial lenders. Among the 11 large MFIs that target

[1] Operational self-sufficiency refers to the ratio of operating revenue over the sum of financial expenses, loan loss provision expenses, and operating expenses. It is a measure of how well an MFI can cover its costs through operating revenues. The adjusted profit margin refers to the ratio of adjusted net operating income over adjusted operating revenue.

broad income groups, the operational self-sufficiency ratio is 109.5%, even though they have a relatively high average loan size of $1,170.

Costs and Interest Rates

The high cost of microfinance demands that MFIs adopt sound practices that will enable them to continue lending sustainably. Rosales (2006, 111) argues that there are four key aspects of a suitable technology in microenterprise lending: 1) analysis of a client's ability to pay based on information about the business's net worth and the client's credit history; 2) the gradual scaling-up of loan amounts, in which institutions grant larger loans after the client demonstrates an ability and willingness to repay; 3) the decentralization of operations, which increases the need for better-quality information systems and clearly-delineated internal controls throughout the institution; and 4) the promotion of healthy competition that discourages over-indebtedness and client predation. Furthermore, MFIs should have at least $1 million in capital, which would allow the institution to absorb losses during a crisis. Related-party lending should be kept to a minimum in order to avoid a relaxation of credit policies. Also, MFIs should seek to expand to the regional or national level in order to avoid geographic or sector risk (Rosales 2006, 114).

Loan operations entail a variety of expenses, such as administrative costs relating to credit operations, the cost of capital, and loan loss provisions for unrecoverable loans (Vento 2006, 57).[2] By one measurement, administrative expenses account for about 23% of the total loan portfolio in Latin American MFIs (CGAP 2002a, 2). Ideally, loan defaults account for about 1 to 2% of the loan portfolio, while MFIs with losses above 5% tend to be unviable (CGAP 2002b, 2). The cost of capital varies for each institution, depending on the balance of debt and equity

[2] The cost of capital is the sum of all costs—from debt and equity sources—that an institution must pay to utilize the funds. The cost of funds is defined as the sum of interest and commissions as a proportion of the average amount of debt held by the institution. Provisions are estimates of the amount of loan portfolio that will not be recovered. They serve as a mechanism for restraining the institution from potential liquidity problems.

used to finance operations. Many NGOs rely heavily on external financing, since they cannot collect savings. As a result, they generally have a higher cost of funds than other institutions.

Table 5-2 presents various financial indices concerning productivity, sustainability, and profitability for 40 Ecuadorian MFIs.[3] Overall, NGOs maintain the highest sustainability indices of all institutional types—133.8% compared to 115.8% for all MFIs. NGOs maintain a relatively low level of portfolio risk (4.2%). Also, loan officers represent a relatively high proportion of total staff members at (42.2%), indicating that NGOs dedicate more of their staff to loan operations. Cull et al. (2008b) found that regulated institutions (i.e., banks and regulated credit unions) have a lower percentage of loan officers because of the need for more administrative staff to assist in complying with regulatory standards. Furthermore, some NGOs, like CEPESIU and Casa Campesina de Cayambe, may benefit from operating in areas presenting little competition.

After factoring in all expenses related to operations, financing costs, and provision requirements, the total cost of microlending can be quite high, especially with the small loan amounts being offered. In addition to these high costs, poor microentrepreneurs are less likely to have a credit history, less likely to provide collateral, and more likely to live in remote areas. For these reasons, interest rates have traditionally been high in microfinance. Nonetheless, high interest rates appear to be only a minor deterrent for microentrepreneurs seeking credit. This is largely because of a lack of other affordable sources of funds, given that *chulqueros* often charge between 10 and 20% interest on a monthly basis (Borja 2002, 78). The only notable advantages of informal borrowing are the lack of minimum requirements and the relative ease of acquiring a loan.

[3] The data for Credife are presented separately, since it is a subsidiary of Banco del Pichincha. This means that some of the financial and operational indicators for Credife may be influenced by that unique relationship.

Interest rates may vary greatly across institutions. The largest banks, including Banco Solidario and Banco Procredit, typically set interest rates near the ceiling determined by the Banco Central del Ecuador (BCE). One tends to find higher interest rates at MFIs that are in various stages of expansion. Among the six credit unions and NGOs interviewed for this study, five charged rates below the legal limit. The exception is the credit union Artesanos which is currently opening new branches and attempting to gain a greater presence in the province of Imbabura.

Some institutions approach interest rates almost exclusively as a means of covering costs. Such institutions tend to be small and characterized by low growth rates. The NGO CEPESIU has been working in microfinance for more than a decade, yet maintains a very small portfolio around $1.3 million. Executive Director Cecilia Padilla explains the organization's growth trajectory and philosophy on interest rates:

> CEPESIU has not achieved, as in the case of other microfinance institutions, great earnings or capitalization. What is the formula to make a sustainable microfinance program that covers financial costs, that covers operative costs, that covers unrecoverable loan costs, and that covers a rate of capitalization? Those four factors make up the interest rate. In the majority of programs, the rate of capitalization becomes the most important in the determination of the interest rate. In that way, the institutions keep generating capital and growing. In our case, our management has always thought that the capitalization rate needs to be at its lowest or, in many cases, if we do not manage to capitalize, it does not matter. The important thing is the cost… that we cover the financial cost, the operating cost, and the cost of [loan loss] risk… We have not managed to reproduce capital with our funds as have other institutions because it has been an institutional policy (Padilla 2010).

CEPESIU is not concentrated exclusively in microfinance operations. The organization has focused largely on projects that promote local economic development and financial access in isolated areas.

Regulating Interest Rates

The regulation of interest rates is an important means of establishing ethical standards in the microfinance sector. The most pointed critique of microfinance is its role in burdening poor individuals with high interest payments. Consider Mexico's Compartamos, where average annual interest rates were about 94% in 2005 (Cull et al. 2008b). Critics of microfinance say that usury exacerbates problems of economic exclusion by placing an additional burden on poor individuals (Feiner and Barker 2006).

Economic theory would suggest that low-income borrowers are capable of shouldering high interest rates (Armendáriz and Morduch 2010). This argument centers on the principle of diminishing marginal returns to capital, which posits that less-capitalized businesses have a higher marginal utility for credit. This means that credit in the hands of a poor entrepreneur will produce a greater proportional return than for a highly-capitalized business. When a poor entrepreneur gains access to capital, they have a number of attractive investment options that a wealthier entrepreneur has already satisfied. In other words, when there is a greater need for capital, there are more opportunities to generate a higher return. MFIs justify high interest rates by citing high profit margins among microenterprises as a result of receiving credit (Villaseca 2010). Some argue that many microfinance clients around the world have managed to pay off their loans repeatedly (CGAP 2002b, 10). However, many microenterprises are concentrated in low-growth economic sectors that will never graduate into small- and medium-sized enterprises, so the principle of diminishing marginal returns to capital may not apply in those circumstances. These enterprises will likely turn to the *chulqueros* when they fail to qualify for a microloan.

Since 2000, the BCE has established interest rate ceilings for the Ecuadorian financial system. This authority was proscribed by Article 8 of the Law for the Economic Transformation of Ecuador, which was passed in the aftermath of the 1999 crisis (Domínguez Sáenz and Naranjo

Zolotova 2009). In Book I of the Codification of Regulations by the BCE, all financial institutions are required to provide consolidated information on a weekly basis, specifying loan amounts, terms, and nominal and effective interest rates. The BCE uses this information to construct the referential and maximum interest rates for that month.

There are also regulations governing financial institutions' provision of information to the public concerning interest rates. The Codification of Regulations (Book I, Title 6, Chapter 8, Article 4) specifies that all institutions must provide reliable information to the public, with respect to the loan payment schedule, the nominal and effective interest rate, the schedule of payments, and the coverage of interest. In June 2007, the government passed the Law for the Regulation of the Maximum Effective Cost of Credit. The bill provides for the use of a new mechanism for calculating interest rates, the elimination of commissions, the segmentation of credit, and the regulation of banking services. Ultimately the Constitutional Tribunal ruled that the new method of interest rate calculation was unconstitutional, and it was later modified. The SBS also reserves the right to suspend any charge to the client that does not correspond to the given service or in situations where the cost and conditions of the price have not been previously presented and confirmed with the client.

Microcredit interest rate caps are determined for three different segments. "Broad accumulation" refers to loan amounts above $8,500 and no more than $20,000. "Simple accumulation" refers to loans above $600 and no more than $8,500. "Subsistence" microcredit totals no more than $600. In order to qualify as a microloan, the microenterprise must register less than $100,000 in annual sales. Since 2007, the BCE has gradually decreased the interest rate cap for microcredit, making it more difficult for MFIs to operate sustainably (Table 5-3). From December 2007 to December 2010, the maximum interest rate for broad accumulation loans

decreased from 30.85% to 25.50%. For simple accumulation loans, the maximum rate dropped from 49.81% to 27.50%. For subsistence loans, the rate dropped from 48.21% to 30.50%.

Decreases in interest rate ceilings affect only the institutions that charge the maximum rate. Many Ecuadorian MFIs are sensitive to the government's efforts to mandate interest rate ceilings. Javier Vaca of the RFR explains,

> The institutions that charge the maximum interest rate are those that have methodologies where the credit official visits the client's workplace or forms groups like village banks. They have higher operating costs and charge a higher interest rate. There are local institutions like credit unions that have an established niche in the market, and their clients go to the institution and meet some tougher requirements… Specialized banks and some credit unions—some seven institutions—are pegged to the upper limit (Vaca 2010).

Institutions that offer very small loans tend to pull away from low-end clients when the interest rate cap decreases. In 2009, FINCA increased its minimum loan from $50 to $200 in order to cover interest rate reductions. After a decrease in the cap last year, the bank considered raising the minimum loan amount to $400. MFIs have also cut back on training regimes for new clients. This may present difficulties for those clients that have limited experience with formal credit (Otero 1986, 87). For some institutions, training has been reduced to a simple discussion of loan policies and repayment schedules (Albán 2010). FINCA now offers training only to those village banking programs that require it (Goldmark 2006, 206).

Recent decreases in interest rate caps have been viewed by some observers as inimical to the industry. In 2009, the Economist Intelligence Unit (2009b) ranked Ecuador 52nd out of 55 countries in its investment climate, largely due to those decreases. Oscar Villaseca, the Director of Credit at Banco Procredit, criticizes those efforts:

> The government does not take a reality into account. There are two types of clients. There is the type of client that is at the subsistence level where their income is equal to their expenditures and nothing is left over. And there is another large segment that has an economic activity and has a business with high levels of profitability… I am not speaking about Coca Cola, for example, which reaches 12,

> 13, 15% profit margins because they have a lot of invested capital. A microentrepreneur easily reaches between 30, 50, 60, 80, 100%… We finance businesses that earn profits, which allow them to cover all of their costs and enough profit for the loan… Forget the idea that the microentrepreneur is very poor. The microentrepreneur has a business that provides good profitability which allows them to pay high interest rates (Villaseca 2010).

This observation invokes the principle of diminishing returns to capital in justifying the relatively high interest rates charged by MFIs. It also reflects the notion that at least some MFIs do not interpret their roles as poverty alleviators.

Regulation and Supervision

Financial regulation is a positive means of encouraging sustainable growth in the financial sector. Regulation is classified as either prudential or non-prudential. Prudential regulation is aimed at protecting the financial system from systemic failure and ensuring the safety of small depositors at financial institutions (Wright 2000). It can be complex and expensive to implement, since it requires efforts from a central banking authority. Examples of prudential regulations include capital adequacy norms, reserve requirements, and liquidity requirements. Non-prudential regulation deals with the conduct of financial operations, such as "enabling the formation and operation of microlending institutions; protecting consumers; preventing fraud and financial crimes; setting up credit information services; supporting secured transactions; developing policies with respect to interest rates; setting limits on foreign ownership, management, and sources of capital; identifying tax and accounting issues; plus a variety of cross-cutting issues surrounding transformations from one institutional type to another" (Christen et al. 2003, 6).

Guachamín Guerra and Cárdenas Martínez (2007, 41) provide three reasons for the importance of incorporating Ecuadorian MFIs into the formal financial system: 1) the opportunity to incorporate new clients in formal financial markets, 2) to increase supervisory

functions that prevent and mitigate crises, and 3) to reduce costs and encourage innovations in risk management. Jordán Bucheli and Román Ferrand (2004, 23) add that supervision also protects Ecuadorian clients from possible fraud and promotes greater efficiency in the market.

Microfinance regulation in Ecuador did not emerge until the early 2000s. There are a few reasons for why it was slow to develop. First, during the 1990s most financial institutions were expanding coverage to individuals that could provide collateral and presented quantifiable risks. Second, the microfinance sector grew largely after the banking crisis of 1999–2000. The crisis was fuelled by a failure to enforce minimum capital requirements and to prevent the proliferation of related loans (i.e., multiple loans belonging to a single individual). The banking crisis likely precipitated a desire for greater government regulation of the financial sector. Third, the over-indebtedness and consumer loan crises in Peru and Bolivia may have diminished the enthusiasm for Ecuador's entry into the microfinance industry. Fourth, the SBS did not create a microfinance division until 2002 (Guachamín Guerra and Cárdenas Martínez 2007, 39–40).

Ecuador's regulatory environment for microfinance is generally well-regarded. In a study of 55 countries worldwide, the Economist Intelligence Unit (2009b) ranked Ecuador highly in terms of its regulatory framework (10th). Documentation requirements are reasonable, and the minimum capital adequacy ratio of 9% is quite favorable.[4] The regulatory environment has been favorable to all types of institutions, explaining the great diversity of institutional structures within the microfinance sector. The SBS has also worked to assist unregulated credit unions in transitioning to regulated status. In January 2011, the Guayaquil-based D-Miro became the first NGO to transform into a bank (SBS 2011). Nonetheless, there are still concerns that too few boundaries exist between microfinance and consumer credit.

[4] The capital adequacy ratio is a measure of a bank's capital over its risk weighted assets. It is an indicator of the institution's ability to absorb losses.

Regulatory Norms

The basis of all financial regulation in Ecuador stems from the Ley General de Instituciones del Sistema Financiero (1994). This law regulates the creation, organization, activities, operations, and extinction of private sector financial institutions through the SBS. There is also a series of Decretos Ejecutivos which apply to credit unions and other institutions, along with several resolutions drafted by the SBS and the Junta Bancaria. The Junta Bancaria has the right to evaluate institutional policies and procedures, ensuring the existence of adequate credit technologies and information systems for tracking the progress of outstanding loans. If institutions fail to meet these minimum standards, they are required to provide a capital provision totaling 3% of the loan portfolio. No single client may be loaned more than 10% of the institution's technical reserves—capital that is set aside to cover future losses—but there are exceptions if the loan is covered by collateral.

The Ley General de Instituciones del Sistema Financiero also requires that financial institutions update information regarding clients' compliance with debt obligations through credit risk centers and authorized credit information bureaus. The compilation of client credit histories alters the dynamics of microlending by revealing information about a client's willingness to repay. In that respect, credit histories also have the potential to subvert collateral requirements by providing a better picture of a client's risk profile.

Before 2002, Ecuadorian financial regulations treated microcredit like consumer credit, since both have high operating costs and loan amounts total no more than $20,000. The primary distinction between the two is that microcredit typically targets informal activities, while consumer credit finances salaried individuals in the formal sector. Consumer credit is typically repaid from a fixed salary, and the ability to repay is determined through credit scoring models

(Berger 2006, 23). The application of consumer lending methodologies in microlending engenders the assumption that microentrepreneurs rely upon a steady supply of income.

The Junta Bancaria passed Resolution 457 in 2002, marking Ecuador's first attempt to delineate regulatory norms specifically for microcredit. Article 1 defines microcredit as the following:

> Microcredit is all credit granted to a borrower, whether an individual or legal entity, or to a group of borrowers with a solidarity guarantee directed toward financing small-scale activities in production, commerce, or services, whose source of income is the product of sales or income generated by said activities which are adequately verified by the lending institution.

Loans are not considered "microcredit" if the original amount exceeds $20,000, at which point the borrower is expected to present financial statements. The resolution also defines documentation requirements for the lender, with respect to information on clients, policies regarding credit technologies, and adequate documentation for each loan. The resolution also acknowledges the need for flexibility in collateral requirements by outlining some guidelines for solidarity group lending: loan amounts may not exceed $4,000, groups must consist of at least three people, members must know each other, and the approval of group loans must be backed by an adequate assessment of each member's ability to repay.

One of the most important contributions of Resolution 457 is the structure for determining loan loss provision requirements. Loan loss provisions are determined by estimating the percentage of overdue loans will not be collected. In the institution's financial statements, this estimate goes into a valuation account, while total assets are reduced to reflect a potential loss. When a debt is actually cancelled or deemed unrecoverable, the provision account is reduced by the amount of the unpaid debt as total assets are written down. Provisions have a restraining function, forcing the institution to set aside certain amounts of capital in anticipation of future losses. The means by which provisions are calculated are highly consequential. If institutions are

required to recognize losses too late, they may underestimate the amount of unrecoverable debt. As a result, the institution could overstretch itself and fail to meet minimum capital requirements.

The resolution specifies a hierarchy for calculating provision requirements for overdue loans: A) normal risk after 5 days, B) potential risk between 5 and 30 days, C) deficient risk between 30 and 60 days, D) doubtful collection risk between 60 and 90 days, and E) risk of loss after 90 days. Within each category, institutions calculate provision amounts by determining the average default rate for each category. When a loan becomes 90 days overdue, the institution is required to recognize a loss, and it must be written off by 180 days after the due date. Consumer credit loans are considered losses after 270 days. This divide illustrates some of the fundamental differences between consumer credit and microcredit.

In 2000, the government passed the Ley Orgánica de Defensa del Consumidor, which outlines a number of protections for Ecuadorian consumers. The law requires that information provided to the consumer should be truthful, sufficient, clear, complete, and opportune in order to ensure an appropriate and reasonable choice (Article 17). Providers are also obligated to give information about the final value of the goods and services they offer (Article 19). Article 47 outlines the major protections regarding credit:

> When the consumer acquires certain goods or services through credit systems, the provider will be obligated to inform him/her in advance, clearly and precisely:
>
> - The net price of the good or service in the transaction;
> - The total amount corresponding to interest, the rate at which it will be calculated; also the delinquency rate and all additional charges;
> - The number, amount, and schedule of the payments to be made; and
> - The total sum to be paid for the good or service.
>
> The establishment and charge of interest upon interest is prohibited. The calculation of interest in the acquisition of credit should be done exclusively upon the balance of the unpaid capital. That is to say, every time that a payment is made,

> the interest should be recalculated in order to avoid covering interest upon the total capital. Everything put forth in this article and especially in this subsection, includes all the institutions of the Financial System.
>
> The provider is obligated to confer receipts for each partial payment. The payment for a corresponding installment for a given period of time presumes that of the previous payments.

Other provisions include the right for a consumer to pay in advance, either in totality or in partial amounts which are larger than a single installment, after which interest will only be paid on the remaining balance (Article 48). In collecting a payment, the consumer will not be exposed to ridicule or defamation, nor any illicit action or threat (Article 49).

Curtailment of Outreach

There are some indications that regulation and supervision may increase costs and cause institutions to curtail outreach to marginalized sectors. A recent study of 245 of the world's largest MFIs found that supervision is associated with higher average loan sizes and less lending to women (Cull et al. 2008b). The central problem is that regulated institutions must absorb higher costs by curtailing outreach to the most vulnerable segments. Supervision does not have a substantial effect on profits, since MFIs absorb the additional costs by targeting higher-income sectors. The data indicate that MFIs subject to onsite supervision employ a smaller share of loan officers and a larger share of office staff dedicated to compliance with regulations.

Data from Ecuadorian MFIs in the RFR confirm that regulated credit unions employ a smaller percentage of loan officers out of their total personnel (27.2%) than unregulated credit unions (30.1%) (Table 5-2). At NGOs, which are unregulated, credit officers account for 42.2% of staff, compared with 30.6% of employees at regulated banks. Nonetheless, loan officers at regulated credit unions assume a much higher number of clients (521) than officers at unregulated credit unions (328). Oscar Villaseca, the Director of Credit of Banco Procredit, notes that regulated institutions are required to maintain the same infrastructure as a traditional bank.

This requires them to have staff that can handle regulatory issues and to create reliable reporting systems that compile financial and operational data in a timely manner (Villaseca 2010).

Competition

Ecuador's microfinance sector has grown increasingly competitive in the last 15 years. During this time, it became readily apparent that microenterprises represented a sizeable and oft-neglected part of the economy. With the emergence of large-scale MFIs in the latter part of the 1990s, the market changed substantially. In 1995, Banco Solidario became the first specialized microfinance bank in Ecuador and adopted the mission of reaching a segment of the population that was previously unattended (Durán 2010). Over the next six years, other major specialized banks emerged, such as Credife and Banco Procredit. In September 2010, these three MFIs held an aggregate loan portfolio of more than $784 million (RFR 2010a). The recent rise of the Ecuadorian microfinance sector has spawned a greater diversity of credit options for microentrepreneurs. While competition is perhaps not as intense in Ecuador as it is in other countries, the rapid growth of competition will undoubtedly shape outreach strategies in Ecuador over the coming years.

In general, there are indications that financial sector growth has a positive influence on outreach. In a global study, Cull et al. (2009) found that the presence of large banks in the economy is generally associated with greater outreach to poorer segments, evidenced by the provision of smaller loans and a greater share of female clients. These findings indicate that the size of the financial sector as a whole is consequential to outreach efforts, since it can encourage MFIs to seek new markets.

The Ecuadorian microfinance market has not reached total saturation. Various sources reported that perhaps 20 to 35% of clients are engaged with multiple lending institutions (Economist Intelligence Unit 2009b; Maldonado 2010; Vaca 2010). Nonetheless, none of the

MFIs in this study reported feeling threatened by the presence of other lenders. Competition in general compels many institutions to innovate and meet client demands for new products and services (Marulanda and Otero 2005). Institutions across the spectrum now offer loans for consumer goods and housing, perhaps as a means of retaining clients.

Some qualitative evidence from Ecuador indicates that competition can have a positive influence on outreach. The NGO CEPESIU has determined that it will not compete with other lenders to the extent that it can avoid them (Albán 2010). This policy is fitting with CEPESIU's social mission, since the lack of competition in certain areas implies that most individuals in those areas have little previous experience with an established financial institution. This case also indicates that competition may incentivize certain institutions to incorporate new market segments when competitive pressures threaten their strategic objectives.

Another small NGO, Casa Campesina de Cayambe, operates largely at the margins of the formal credit market. The organization is headquartered in the small town of Cayambe in Ecuador's northern highlands, but Casa Campesina has no clients within the urban sector. This is due to their long-standing mission of providing financial services to the rural indigenous communities within the area (Vinueza 2010). Also, there is already an array of credit providers within the city of Cayambe. In the future, if large-scale MFIs continue to innovate and assume a greater presence in isolated markets, small NGOs may have to implement major technological innovations or adopt different methodological approaches in order to continue operating in certain areas (Marulanda and Otero 2005, 2).

It is not clear that the cases of Casa Campesina and CEPESIU are indicative of the Ecuadorian microfinance industry as a whole. For example, Sebastián Maldonado of the credit union Maquita Cushunchic, which has operated exclusively in Quito since 1998, argues that

growing competition from MFIs like Credife and Procredit has not diminished the institution's growth trajectory. Also, the credit union Artesanos has continued to grow with the bulk of its operations in the city of Ibarra. Of course, credit unions are generally known for maintaining close ties with clients in local communities, so client retention can remain quite steady (Torre 2010).

From a client perspective, competition can be a positive factor since it increases the range of available options in the market. It creates transparency in determining market interest rates and gives clients an opportunity to choose an institution that will provide them with the best terms (Rosales 2006, 115). Furthermore, the expansion of the microfinance sector may lower certain implicit costs to the client, by gaining closer proximity to an institution and utilizing more convenient lending methodologies.

Market Saturation and Over-indebtedness

At this point, the growth of competition probably has not been extensive enough to force most MFIs into targeting new segments. One problem might be that MFIs are extending more credit to the same clients. Over the last few years, Ecuadorian MFIs have been growing faster in terms of loan portfolios rather than the number of active clients at the institution. This indicates that clients are taking on higher amounts of debt than before. Over-indebtedness has caused systemic crises for MFIs in other countries. During the 1990s, the Bolivian microfinance sector became deeply over-saturated, leading to predatory competitive practices and over-indebtedness that compromised the quality of the microcredit portfolio (CGAP 2001, 9–10). As mentioned earlier, competition can become a positive force if it encourages the incorporation of financially inexperienced microentrepreneurs, rather than increasing credit among the same group of clients. McIntosh et al. (2006) found that competition in Uganda has not precipitated client dropout or exodus from certain institutions, but it has generated a decline in deposits and repayment

performance. Clients often carried loans with multiple institutions. Because of the minimum savings requirements at many institutions, clients also had to spread their deposits across those different institutions. That clients did not abandon the incumbent institution is an indication that the Ugandan market has not reached saturation.

The Ecuadorian market has not reached saturation, but there is some evidence that competitors are becoming more aware of each other's presence. Client retention is an important means of making microfinance a sustainable activity. Yet there have been some recent occurrences of client predation within Ecuador. Recently, an executive from FINCA resigned for political reasons and relocated to another institution where they managed to capture 40% of FINCA's clients, including entire village banks (Vaca 2010). Also, there have been cases in which institutions offered to pay off an individual's existing debts and provide a new loan at a higher amount or with more favorable terms. Such practices encourage clients to distribute their savings and loans among multiple institutions.

Closely linked to the issue of market saturation is the problem of over-indebtedness and cross-indebtedness. Over-indebtedness refers to those cases in which a borrower assumes more debt than is required or when the amount of debt exceeds the capacity for repayment. Cross-indebtedness—also known as "double-dipping"—refers to situations in which a borrower carries loans from multiple institutions. Maquita Cushunchic conducted a study through their credit bureau and found that 35% of their clients had loans with multiple lending institutions (Maldonado 2010). The MIX Market (2010b) determined that 75.5% of Ecuadorian clients work exclusively with one institution. Javier Vaca, the Executive Director of the RFR, notes that perhaps 80% of clients have only one loan, but the remainder holds loans from multiple institutions:

> Above all, competition has increased in urban areas, and there are several institutions that offer credit. On the one hand, it is competition among MFIs for microentrepreneurs but also one sees a phenomenon in which the consumer credit banks are entering this market. Also, there are commercial stores where, because a client, a microentrepreneur has already repaid several loans and has a credit history registered in a credit bureau, it is easy for a commercial store or a consumer credit bank to offer credit, offer a credit card, because they already have a very good credit history. And this has caused over-indebtedness to grow… We see that around 80% of clients continue with only one credit in the institution, but there are about 20% of clients that have credit with two, three, even four other institutions. One sees that there is growth coming not necessarily in the form of clients but by granting two loans to one client (Vaca 2010)

MFIs should be concerned about the growth of competition with respect to the number of loans per client rather than the number of clients.

Maximum Loan Amounts and the Graduation of Clients

Some MFIs have difficulties in retaining clients that demand higher loan amounts than the institution is capable of providing. Most institutions do not report problems with the graduation of clients to larger institutions, but it can be a source of frustration for smaller institutions. NGOs and credit unions that impose relatively low ceilings on loan amounts sometimes fail to retain their most successful clients. CEPESIU is vulnerable to this problem, since loans are capped at a relatively meager $3,000 (Albán 2010). Those clients that manage to grow their businesses and achieve some level of financial literacy are ultimately forced to seek financing at larger institutions.

Placing a ceiling on loan amounts may serve as both a measure of financial prudence and also as a means of adhering to the social mission of the institution. Victor Hugo Albán (2010), the Director of Credit at CEPESIU, describes this dual objective:

> Regarding [low maximum loan] amounts, it is primarily because of CEPESIU's economic and financial limitations, not being a financial intermediary… not having a permanent source of funding. What CEPESIU has to do is search for entities that will lend to us in order to lend to these clients, and generally they are entities that naturally support microenterprise development in developing countries… When you talk about a client that demands $10,000, he/she certainly is not a

> microentrepreneur anymore. Perhaps in the beginning they were microentrepreneurs, but now they no longer are… So that's the difference, and at our level many clients reach $3,000 after several loans with us. A person starts with $500; let's say the second is $800, later $1,000, $1,400, $2,000. In order to arrive at $3,000, he/she had to go through three or four years, but those are three or four years where we have gone in and trained them to honor their debts… I would say that 10% of my clients demand higher amounts than $3,000.

Sometimes MFIs adapt policies to offer higher loan amounts and retain clients. At the credit union Artesanos, the maximum loan amount is $11,500, but it is possible to receive a joint loan of $23,000 to be shared between a husband and wife (Carrasco 2010). This may raise some concern, as clients may be able to coerce their spouses into accepting a debt for which they are not responsible.

Discussion

Ecuadorian MFIs confront a variety of internal and external constraints that shape outreach policies. The focus on maintaining sustainable financial systems requires a perpetual cost-benefit analysis of institutional credit policies and loan products. The sustainability paradigm does not necessarily present a tradeoff with poverty outreach. The general dearth of donor subsidies has required that MFIs innovate and moderate outreach to riskier client segments. Serving lower-income clientele bases may be more profitable than serving a broad clientele base. In the end, it may not be necessary to abandon the poor in order to grow.

Interest rate regulation has become a point of contention within the industry. The BCE's interest rate cap has declined steadily since 2007, bringing some MFIs to raise their minimum loan amounts and cut certain operational costs. This may have a negative impact on poverty outreach efforts.

Government regulation of the microfinance sector has increased since 2002, when the SBS created a microfinance division. New regulations are notable in establishing clear rules for the determination of loan provisions, which are used to protect the financial system from widespread

credit default. MFIs are also obligated to provide clear information to clients concerning the terms of the loan. Global studies indicate that the regulation of the microfinance sector may curtail outreach to economically marginalized individuals. Regulated MFIs generally dedicate a smaller proportion of total staff to credit operations, while other staff are committed to compliance with regulatory standards.

Competition has grown steadily over the last decade. There are indications that the growth of competition has encouraged the incorporation of new individuals, but many institutions reported no changes in terms of their outreach strategies. There are concerns that much of the current competition is fuelled by cross-indebtedness and over-indebtedness. About 20–35% of clients belong to multiple institutions. This may become a problem in the future if institutions fail to consider clients' credit histories and current levels of indebtedness. Competition may also complicate client retention as the number of market options continues to grow. Smaller institutions that offer low maximum loan amounts have to incorporate new clients as experienced clients graduate to larger financial institutions.

Table 5-1. Average financial and outreach indicators for 56 Latin American microfinance institutions, November 2002

Scale, target group (count)	Operational self-sufficiency	Financial self-sufficiency	Yield on gross portfolio	Adjusted profit margin	Average outstanding loan size	Depth	Women borrowers
Large, broad income (11)	109.5%	102.5%	33.6%	1.8%	$1,170	77.6%	50.2%
Medium, broad income (8)	100.3%	89.1%	47.1%	-20.0%	$468	61.1%	66.3%
Medium, low income (9)	145.9%	136.7%	54.0%	22.1%	$239	15.1%	83.6%
Small, low income (5)	86.8%	65.8%	52.0%	-63.3%	$211	17.6%	88.2%
Small, upper income (5)	99.2%	85.2%	61.2%	-15.0%	$625	14.0%	64.0%
Credit unions (18)	110.6%	84.4%	23.2%	-28.4%	$814	58.9%	42.5%

Notes: Operational self-sufficiency = operating revenue / (financial expense + loan loss provision expense + operating expense). Financial self-sufficiency = adjusted operating revenue / adjusted (financial expense + loan loss provision expense + operating expense). Yield on gross portfolio = cash financial revenue from gross loan portfolio / average gross loan portfolio. Adjusted profit margin = adjusted net operating income / adjusted operating revenue. Average outstanding loan size = gross loan portfolio / number of active borrowers. Depth = average outstanding loan size / GNP per capita. Women borrowers = number of active women borrowers / number of active borrowers. Source: Elaborated by author from MIX Market 2002.

Table 5-2. Average financial and operational indicators for Ecuadorian microfinance institutions in the Red Financiera Rural, September 2010

	Banks	Auxiliary services (Credife)	Unregulated credit union	Regulated credit union	NGO	Total
Number of institutions	3	1	15	8	13	40
Portfolio at risk (total)	7.92%	2.39%	5.75%	3.47%	4.23%	4.75%
Portfolio at risk (>30 days)	2.36%	1.54%	4.18%	3.16%	2.76%	2.80%
Rate of punishment	3.42%	1.86%	0.44%	0.39%	0.70%	1.36%
Microcredit portfolio / total portfolio	79.5%	100.0%	69.8%	50.9%	98.4%	74.2%
Operational sustainability	109.54%	110.00%	104.21%	121.28%	133.78%	115.76%
Financial sustainability	107.66%	60.39%	101.68%	112.80%	121.53%	100.81%
Return on assets	1.01%	0.30%	1.56%	1.96%	4.70%	1.91%
Return on equity	6.28%	20.82%	9.75%	12.26%	14.85%	12.79%
Portfolio per staff member	$221,450	$587,102	$203,768	$413,297	$130,465	$311,217
Clients per staff member	126	181	103	154	173	147
Portfolio per credit officer	$793,655	$889,884	$648,434	$1,588,000	$309,795	$845,954
Clients per credit officer	392	275	330	564	385	389
Credit officers as percentage of staff	30.58%	65.98%	30.05%	27.19%	42.16%	39.19%
Savings per staff member	$46,228	N/A	$80,765	$243,757	N/A	$370,750
Performance of the portfolio	21.46%	N/D	15.50%	15.45%	19.98%	15.58%
Cost of funds	6.28%	N/D	5.14%	4.53%	7.87%	4.77%

Notes: Operational sustainability = financial income / (financial expenditures + net provision expenditures + operational expenditures). Financial sustainability = adjusted financial income / (financial expenditures + provision expenditures + operational expenditures) adjusted. Performance of the portfolio = (portfolio income - interest) / average loan portfolio. Cost of funds = (interest expenses and commissions) / average loan funds. Source: Elaborated by author from RFR 2010a.

Table 5-3. Interest rate caps and average interest rates for regulated financial institutions in Ecuador, 2007–2010

	Broad accumulation ($8,500–20,000)		Simple accumulation ($600–8,500)		Subsistence (<$600)	
Date	Average	Maximum	Average	Maximum	Average	Maximum
Dec. 2007	23.50%	30.85%	31.55%	49.81%	41.47%	48.21%
Dec. 2008	22.91%	25.50%	29.16%	33.30%	31.84%	33.90%
Dec. 2009	23.29%	25.50%	27.78%	33.30%	30.54%	33.90%
Dec. 2010	23.11%	25.50%	25.37%	27.50%	29.04%	30.50%

Source: BCE 2011.

CHAPTER 6
CONCLUSION

Microfinance institutions seek to optimize double bottom line returns—achieving a balance between social and financial returns. In this study, I have evaluated the development of the Ecuadorian microfinance sector and the complex relationship between outreach and sustainability. Two major dimensions of outreach have been analyzed. Breadth of outreach refers to the coverage of MFIs and the incorporation of new clients, while depth of outreach refers to the incorporation of poor microentrepreneurs and women. MFIs have to determine how to optimize these objectives while maintaining sustainable financial systems. Some institutions look to satisfy only the minimum sustainability requirements, allowing them to reach a relatively small number of marginalized clients. Other institutions are oriented toward growth objectives that allow them to reach a relatively large number of clients, but those clients tend to come from a much broader socioeconomic base.

Breadth of Outreach

Ecuadorian microfinance has grown dramatically over the last decade. Between 2005 and 2009, the total loan portfolio for a group of 34 MFIs grew by 112%, while the total number of clients served grew by 46%. These figures highlight a broader trend in the industry, in which much of the recent growth has come in the form of existing clients taking out larger amounts of debt.

It is not clear how many microentrepreneurs rely upon MFIs for credit. The 2004 survey by the USAID indicates that about 16% of microentrepreneurs received an institutional loan in the previous 12 months. A large number of clients rely upon informal sources of financing, especially from family members and friends. Such sources are heavily utilized for start-up costs,

since MFIs generally require at least six months of experience with a given business activity before granting a loan.

In geographic terms, MFIs still remain fairly concentrated around the country's major urban centers, but large-scale MFIs have made strides in expanding their coverage to less populated provinces in the last five years. Credit unions are the most ubiquitous providers of financial services in Ecuador, and they are the dominant sources of financing in rural areas. Reaching rural areas entails a great expense to the institution, since it requires an extension of the institutional infrastructure to sparsely populated areas. Most of the institutions included in this study did not feel threatened by the growth of large-scale MFIs in recent years, even in major metropolitan markets. I conclude that competition is not yet intense enough to force MFIs to expand their coverage to new markets.

Group lending methodologies are an effective means of expanding microfinance services to isolated communities in Ecuador. Nonetheless, group lending still represents only a small portion of all microfinance services because of the relative convenience of individual-liability credit. Some institutions specialize in the formation and strengthening of autonomous savings and loan entities in rural areas. The NGO CEPESIU has formed a number of SPIs, which are built solely upon the savings of their members. The credit union Codesarrollo lends to local financial structures around the country, while the NGO FEPP, which is the majority owner of Codesarrollo, provides training and technical assistance to the administrators of those local financial structures. I argue that these innovations may represent a viable means of expanding financial services to more isolated areas of the country.

Depth of Outreach

Ecuadorian MFIs largely serve clients that are above the poverty line. Microfinance services tend to be most concentrated among microentrepreneurs of higher socioeconomic status.

This is particularly true among banks and credit unions, but NGOs have a more equitable distribution of clients at all socioeconomic levels.

Minimum requirements at institutions can be prohibitive for very poor clients. All of the institutions in this study require that a business be in operation for at least six months before a loan may be granted. From an institutional perspective, the failure rate for business start-ups is around 30 to 40%, so it would be impossible to remain a sustainable financial institution with that level of risk. From a client perspective, the experience requirement creates two problems. First, MFIs are not a reliable source of funding for individuals that do not have some alternative source of start-up capital. In other words, microfinance cannot generate investment opportunities for individuals that begin with nothing. Furthermore, most credit unions require that clients have a minimum savings balance before receiving a loan. Second, microfinance only serves individuals that already have the requisite skills to run a business and generate a profit.

Institutions always set a minimum loan amount, since it is difficult to cover costs when loan amounts are very small. It is uncommon to find institutions that lend amounts smaller than $300 to $400. In some cases, minimum loan amounts are very high. This obviously prohibits microentrepreneurs that cannot assume a large amount of credit. For example, Banco Procredit now imposes a minimum loan amount of $2,000. The bank claims that this decision was motivated by the perception that many other institutions are already providing small amounts.

The incorporation of women is also an important goal of outreach. Women often start microenterprises because of household constraints. In Ecuador, women's microenterprises tend to be concentrated in commerce activities, and they typically generate less sales revenue than men's businesses. Women generally take out smaller amounts of credit than men, and they tend to express greater concern over indebtedness.

Various data sources indicate that women represent about half of all microfinance clients in Ecuador. Women clients tend to be more concentrated among NGOs, along with MFIs that utilize group lending techniques. Some institutions in this study, like the credit unions Mujeres Unidas and Maquita Cushunchic, were initiated as a response to women's exclusion from financial institutions. Other institutions, like the NGO ESPOIR, lend almost exclusively to women. At each of these institutions, the percentage of female clients has declined since those institutions were opened. In the case of Mujeres Unidas, this trend is attributable to an effort to incorporate the male family members of the institution's female clientele. In the case of ESPOIR, the institution now allows a maximum of 20% men for certain loan products, a move that is designed to aid the growth of the institution.

Growth and Sustainability

Ecuadorian microfinance grew during a time in which many microfinance industries around the world were undergoing a paradigm shift. The previous focus on donor-subsidized "poverty lending" was replaced by a "financial systems approach," which stressed the importance of maintaining positive financial indicators.

Ecuadorian MFIs have different philosophies about the importance of institutional growth. Some of the institutions included in this study were in the process of opening new branches and expanding the institution. Such institutions, like Banco Procredit and the credit union Artesanos, generally charged high interest rates to cover the costs of growth. On the other hand, there are institutions that emphasize social returns over profits. The NGO CEPESIU, for example, charges interest rates that provide a minimal profit margin. Even though the institution has been operating since 1983, it has a loan portfolio of less than $2 million.

I argue that an institution's philosophy on growth has a direct effect on outreach. Those institutions that stress growth and profitability are better able to expand their breadth of outreach.

In order to generate substantial financial returns, institutions have to incorporate clients that demand larger amounts of credit. However, this does not necessarily mean that institutions abandon the poor in order to grow. The institution may broaden its clientele base to include a mixture of lower- and higher-income clients. By contrast, those institutions that maintain a narrow focus on reaching marginalized individuals may develop a strong depth of outreach, but they will not achieve a scale of operations that will allow them to reach a large number of clients.

Contributions to the Literature

The development of the Ecuadorian microfinance sector reflects many of the same challenges facing microfinance institutions around the world. Nonetheless, there are a few characteristics that distinguish the Ecuadorian case.

First, Ecuadorian microfinance arose during the 1990s and early 2000s at a time when microfinance was becoming a large-scale, sustainable activity. Ecuador is not a pioneer in microfinance. In fact, two of the major microfinance banks—Banco Procredit and FINCA—are branches of international microfinance organizations that already had operations in Latin America before entering the Ecuadorian market. ACCION International has a role in the governance and the development of new products at Banco Solidario. Credife is a subsidiary of one of the country's largest banks—Banco del Pichincha. In countries like Bangladesh, MFIs began at a small scale and commercialized into large-scale financial entities. This commercialization process is generally associated with mission drift, but in the case of Ecuador, the major microfinance banks were able to commercialize in a relatively short period of time. I posit that this model of microfinance may become increasingly ubiquitous around the world, as international microfinance organizations expand their horizons to countries with undeveloped microfinance markets.

Second, there are a number of interesting cases in which institutions are working with autonomous financial structures in rural areas. For example, Codesarrollo finances local savings groups and small cooperatives that need larger amounts of credit and technical assistance. CEPESIU has been working with SPIs, some of which have grown from a few hundred dollars in savings to more than $70,000. The development of savings and loan groups may represent a major improvement in microfinance outreach in the future.

Finally, the Ecuadorian microfinance sector is an interesting case with respect to the regulation of interest rates. In some countries, microfinance has gained a notorious reputation for the high rates of interest charged by lenders. However, the BCE has taken major steps in reducing interest rate caps in the last few years. In 2007, interest rates were capped at 48.21% for loans of less than $600. By 2010, the maximum rate had been reduced to 30.5%. This policy move has had a direct impact on a number of major MFIs. FINCA, for example, has raised its minimum loan amount and streamlined certain training services if they are deemed unnecessary. Banco Procredit acknowledged feeling pressured by the government's insistence on lowering interest rate caps. This policy development illustrates the compromises that often arise between outreach and sustainability in microfinance.

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BIOGRAPHICAL SKETCH

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