Opportunities for the creation of linkages and alliances to expand the supply of rural financial services: José María Covelo Foundation and its partners in Honduras*

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LATIN AMERICA
HONDURAS
JOSÉ MARÍA COVELO

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Acronyms

ADELSAR | Agencia de Desarrollo Estrategico Local
AMPRO | Asociacion de Micropresarios y Productores de Occidente
ANDI | Asociación Nacional de Industriales
ASONOG | Asociacion de Organismos no Gubernamentales
BANADESA | Banco Nacional de Desarrollo Agrícola
BANHPROVI | Banco Hondureño para la Producción y la Vivienda
BCIE | Central American Bank for Economic Integration
CAFTA | Central American Free Trade Agreement
CICAL | Cooperativa Industrializadora de Alimentos Limitada
CN | Honduran National Congres
CNBS | Comisión Nacional de Banca y Seguros
CREHO | Fundación Crédito Educativo Hondureño
CSR | Corporate Social Responsibility
DR | the Dominican Republic
ERP | Enterprise resource planning
FAM | Fondo de Auxilio Mutuo
FHIA | Honduran Foundation for Agricultural Research
FINTRAC | Financial Transactions Reports Analysis Centre
FONADERS | National Fund for Sustainable Rural Development Project
FONAPROVI | Fondo Nacional para la Producción y la Vivienda
FUNDASIN | Fundación Aquiles Samuel Izaguirre
FUNDATEC | Fundación Tecnológica Felipe Antonio Peraza
HDH | Hermandad de Honduras
IDB | Inter-American Development Bank
INCA | Empresa comercializadora
INE | Instituto Nacional de Estadística
JICATUYO | Fundación Jicatuyo
MSME | Micro Small and Medium Enterprise
NGO | Non-governmental Organization
ONILH | National Organization of the Lenca Indians
PDO | Private Development Financial Organization
<table>
<thead>
<tr>
<th>Acronimo</th>
<th>Descripción</th>
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<tr>
<td>PILARH</td>
<td>Asociación Proyecto e Iniciativas Locales para el Autodesarrollo Regional de Honduras</td>
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<td>POPULAR</td>
<td>Popular, Asociación ahorro y préstamo</td>
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<tr>
<td>REDMICROH</td>
<td>Red de Instituciones de Microfinanzas de Honduras</td>
</tr>
<tr>
<td>SANAA</td>
<td>Servicio Autonomo Nacional de Acueductos y Alcantarillados</td>
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<tr>
<td>UMA</td>
<td>Unidades Municipales Ambientales</td>
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Opportunities for the creation of linkages and alliances to expand the supply of rural financial services:
The José María Covelo Foundation and its partners in Honduras

Abstract: The case study José María Covelo Foundation in Honduras describes an interesting story of the foundation’s evolution from a typical second-tier organization providing capacity building training and funding to private development finance organizations (PDOs) to one of a highly sophisticated holding company offering financial, human resource management, administrative, systems, marketing and organizational services to six organizations of the holding group. The study focuses on a multiplicity of intra- and extra-group linkages with a range of financial and non-financial actors. The authors examine market-deepening linkages for rural finance and provide in-depth analysis of two local organizations and their linkages with Covelo Group among others. This case is rich in detail and at times complex, but provides many lessons for those interested in following a similar institutional development path.

Introduction

An expansion of the supply of financial services into the rural areas of developing countries is not an easy undertaking. Those financial entities that seek to establish a rural presence face numerous obstacles, including the high costs of overcoming the information, incentive and contract enforcement problems typically found in financial transactions, and the high systemic risks associated with operating in local markets. These obstacles make an increase in their rural outreach a slow process. There are, as well, managerial, funding, and regulatory constraints that frequently keep some organizations from offering a wider range of financial services to their actual and potential rural clientele.

In addressing these challenges, some organizations take advantage of their greater proximity (e.g., geographic, sectoral, cultural, ethnic) to particular classes of rural clients, but they can usually offer only a narrow range of financial services, given the constraints resulting from the local nature of their operations. These organizations may address the limitations either by:

- developing a comprehensive, in-house organizational structure – that is, by directly offering a whole range of financial services through a network of their own branches – a la PRODEM in Bolivia, or

- creating the equivalent of a planetary system – that is, by making a series of services available to their clientele through a number of institutional linkages and alliances, developed around a core program activity.

This case study focuses on the activities of the group of organizations known as the Covelo Foundation, in Honduras, and of two non-governmental organizations (NGOs), namely Hermandad de Honduras (HDH) and the Asociación Proyecto e Iniciativas Locales para el Autodesarrollo Regional de Honduras (PILARH). Both NGOs offer financial services in rural areas and are part of the network of partners of the Covelo Foundation. The experience of these three organizations offers interesting lessons about strategic alliances,
linkages, and relationships created to promote an expansion of the outreach of microfinance organizations into the rural areas of a poor country.

Despite the important achievements of some microfinance organizations, rural financial markets have been comparatively shallow in Honduras, and in the past most gains in outreach have not been sustainable. In addition, these markets have recently suffered important setbacks, mostly from the political interference that has accompanied legislated loan pardoning and has discouraged private bank intermediation. Moreover, in recent decades, very few, if any, of the numerous interventions and schemes designed to assist rural development in Honduras – including policies, projects and strategies for the promotion of formal and informal finance – have managed to trigger the kinds of organizational linkages and alliances that could reverse the productive, environmental, and social degradation that has characterized the country during this period. Instances of success have thus remained as isolated cases.

This case study shows, nevertheless, that linkages and alliances between second-tier institutions and financial organizations with an established presence in some agricultural regions have the potential to trigger positive local impacts among their clients. Indeed, the resulting access to these services seems to have contributed to the alleviation of poverty, chiefly by improving the borrowers’ links to all types of markets and by thereby allowing a diversification of their sources of income toward non-farming activities. Some additional key questions to be addressed, however, are the following: Why, despite some successful experiences, it has not been possible to broadly replicate them in the rural areas of Honduras? Why, even when a first-tier organization has entered into an alliance with a second-tier institution and it has developed close bonds with its clients, it cannot increase the scale of its operations? Why is the sustainability of this kind of organization so fragile? Answers to these – quite universal – questions may shed some light on preconditions for the robustness of linkages between financial organizations.

The Chapter is structured into five sections. The rest of this section summarizes the conceptual and methodological framework for the case study. Section 2 analyses the country context, including key economic and rural indicators, decisive events that have changed the country’s rural development paradigm, and the policy and legal framework for rural financial intermediation. Section 3 explains the logical frame for the activities of the José María Covelo Foundation, as a private development organization involved in the financial services industry, and it highlights three main phases in its evolution. Section 4 analyses the specific linkages developed between the Covelo Foundation and HDH and PILARH, respectively, as well as the alliances developed by each one of these NGOs on its own. This section highlights the vulnerability of these organizations, despite the linkages. The final section identifies lessons learned and conclusions.

**Conceptual and methodological approach**

The case study adopts several conceptual perspectives for the analysis. First, it starts from the premise that the dynamics of development in the rural areas vary according to their agro-ecological, productive, and social conditions. In part by ignoring this, the public policies adopted to encourage rural development in Honduras have failed to promote the kinds of synergies that would have the potential to sustain rural financial market deepening. Because these synergies can be quite powerful, stronger linkages and alliances among market actors and development agents – at both the national and the rural levels – would not only allow local
financial organizations to expand their outreach but also to develop lending technologies better adapted to specific local circumstances.

Thus, a territorial approach is one of the conceptual frameworks used here as a platform for the analysis (and it is one that should be used for the implementation) of initiatives and policies at the rural level. This approach follows De Janvry and Sadoulet (2004), who have justified the differentiation between favourable rural areas and marginal rural areas and have suggested the use of this distinction as a guide in creating greater value added in the rural areas, in promoting linkages between urban and rural areas, and in incorporating the poor into markets for labour and products.

Second, the case study incorporates a concept of livelihoods to highlight the complexity of farm-household strategies, particularly critical in examining the relationships of the local organizations with their clients. Third, following the recent contributions of Lederman (2005) and Jansen, Sieguel, and Pichón (2005), the study stresses the importance of secure access to a bundle of assets in promoting rural development. Fourth, the case study uses the distinction, introduced by North (1993), between institutions – defined as the rules that constrain behaviour, including the governance of organizations – and organizations – defined as the actual structures that allow various forms of collective action. Finally, the analysis makes use of concepts of horizontal organization, to evaluate alliances, linkages, and structures across organizations.

This case study examines the evolution of the Covelo Foundation, an organization with operations at both the first-tier and the second-tier in the provision of financial services (Falck et al., 2006). The profound-change approach introduced by Senge et al. (2000) is used to study the development of the Foundation’s linkages and alliances. This approach describes organizational change as a whole, combining internal modifications (values, approaches, and aspirations) with external changes (strategies, practices, and systems). The analysis of profound change at Covelo starts from the premise that various linkages and alliances have generated significant learning within the organization. The case study isolates and characterizes the various relationships and draws key lessons from these experiences.

Linkages are classified into two types. On the one hand, there are backward linkages, with organizations such as the National Commission on Banking and Insurance (CNBS), financial policymakers, including the Honduran National Congress (CN), and donors and other financial institutions. On the other hand, forward linkages are developed with first-tier organizations, such as HDH and PILARH.

HDH and PILARH concentrate their operations in three of seven agricultural regions, characterized by the mountains and valleys of the coffee-growing region of western Honduras and by the mountains and hills of southern Honduras, respectively. The linkages and alliances between each one of these two organizations and other formal and informal institutions beyond Covelo, as well as the bonds with their clients, are also considered. This makes it possible to cover the entire value chain of rural financial services in these three agricultural regions and to identify the connections of the chain with the policymaking processes.

The case study is based on a review of documentation and on interviews with Covelo managers, to evaluate the role of the linkages in relation to rural development and financial policies, at large, as well as on interviews with executives, the technical staff, and clients of both first-tier organizations. Further, executives and staff of Banco de Occidente, which keeps alliances with both HDH and PILARH, were also interviewed. Consequently, the case study reports their perceptions, evaluated in the light of a systematic review of documentation about trends in the economy, rurality, development policies, and organizations.
Country context

This section briefly discusses three dimensions of Honduras relevant to the case study: (i) the characteristics of rurality, with special attention to the sector’s diversity and processes of differentiation; (ii) main trends in the economy, with a comparison of the situation pre- and post-Hurricane Mitch; and (iii) a summary of the current legal framework for rural and financial matters.

The rural sector in the aggregate economy

Honduras is characterized by substantial rural diversity, accompanied by unstable economic growth, marked income inequality, and widespread poverty, particularly in the rural areas. Assorted environmental conditions, a varied territorial profile, and climate have favoured diversity in rural organization. This has resulted in the differentiation of seven agricultural regions, marked by deep regional inequalities. The availability of water has led to a pattern of land use centred on the so-called T of development (T del desarrollo), which combines humid and dry tropics, and of which the Puerto Cortés-Choluteca corridor forms the stem and the Atlantic coast forms the top of the T. Sixty per cent of the Honduran population is concentrated in this area, which includes the country’s main cities and the majority of its infrastructure of roads, telecommunications, airports, and electric supplies as well as the largest and most important valleys. Striking backwardness characterizes the rural areas excluded from the T of development where, by and large, poverty is concentrated.

Policy reforms have not been sufficient to reverse the social and environmental degradation that compounds poverty, with losses in marginal areas from drought, soil erosion, and floods that increase each year. This unfavourable state of affairs has been exacerbated by the variability of coffee and oil prices, in augmenting agricultural risks and in putting pressure on the country’s balance of payments (Falck, 2004).

Income per capita has grown slowly. The annual rates of growth of GDP averaged 3.4 and 2.8 per cent in the 1980s and 1990s, resulting in rates of growth of per capita GDP of 0.3 and 0.1 per cent, respectively. In recent years (2000–2004), rates of growth of GDP ranged between 4.3 and 5.7 per cent, with a population growth rate of 2.6 per cent per year (1988–2002). Thus, per capita income was less than US$950 in 2002. According to the World Bank’s classification of low income countries, in 2002 Honduras ranked 144th among 201 countries. In 2003, the UNDP Human Development Index was 0.657 for Honduras, below the Latin American and Caribbean average of 0.777, and the country ranked in the 115th place among 175 countries (Falck and Pino, 2003).

Agriculture’s share in the GDP shrank, from 20 per cent in 1992 to less than 14 per cent in 2001 (Bustamante and Falck, 2005). Still, agriculture accounted for 34 per cent of total employment in 2000, compared to 39 per cent employed in the informal sector (Sauma, 2001). The contrast between the share of agriculture in employment and its contribution to the GDP is an indication of the low productivity of labour in agriculture. By 2004, about 55 per cent of the country’s population lived and 34 per cent of its labour force worked in the rural areas (Instituto Nacional de Estadística, INE).

Despite their limited reliability, all sources agree that the incidence of poverty is concentrated in this rural sector. According to the Ministry of Agriculture, 75 per cent of the rural population was poor in 2004. INE confirmed that, in 2003, two out of every three Hondurans were poor and that three out of every four poor Hondurans were extremely poor. At the turn of the century, the Gini coefficient for the distribution of income was 0.564, where
the poorest 40 per cent of the population earned only 12 per cent of total income, whereas the richest 10 per cent earned 37 per cent.

Decisive events

Three decisive events marked a return to a rural approach in Honduras, with a new vision of investing in the rural areas, in order to raise competitiveness. The new approach uses a value chain perspective and focuses on public interventions and policies that improve access to a package of what are assumed to be engines of economic growth and rural development, including rural finance and access to knowledge.

The first decisive event was Hurricane Mitch, which struck Honduras in 1998, with losses equivalent to at least 70 per cent of its GDP. This event marked a change in the country’s development paradigm, by showing that the earlier anti-rural bias of policies and, especially, the polarization caused by targeted subsidies had resulted in great vulnerability, in terms both of environmental and social capital, thereby exacting high economic and social costs. Instead, rural areas with fragile ecosystems are now being considered as strategic in planning interventions and investments by the public sector, private development organizations, and international agencies. This paradigm change stemmed from three main factors: (i) the fragility of rural production systems (hillsides and valleys); (ii) rural depopulation, because of migration; and (iii) a reduction in forest cover, because of the expansion of livestock holdings (the ganaderización of agriculture). The new approach emphasizes local development, governance, microenterprises, and microfinance, in efforts to build human and social capital in the rural areas and reduce environmental and social vulnerability.

The second decisive event was the recent fall in coffee prices, which highlighted the vulnerability of the economy vis-à-vis international price fluctuations and concentration in a few export crops. This has called for a revamping of the country’s trade strategies, which will have significant influence on the rural areas, where one out of every four farm producers is a coffee grower. These two events highlight the importance of mechanisms to address systemic risks, including the role of access to financial services (deposits and loans) for consumption smoothing and the potential role of indexed insurance.

The third decisive event has been the inclusion of Honduras in the Free Trade Agreement between the United States and Central America and the Dominican Republic (CAFTA/DR), with the opportunities that it creates and the concerns about the competitiveness of traditional agriculture that it raises (Monge-González, Loria and González-Vega, 2004; Lederman, 2005). Increased competitiveness has been identified as key for rural development. This has prompted several development agencies to use approaches centred on value chains. In turn, this has led to a debate on investment in education as a key factor in promoting change. All of this has culminated in the drafting of a National Competitiveness Plan in 2005, expected to assist in donor coordination.

The policy and legal framework for poverty reduction, rural development, and financial regulation

Prior to Hurricane Mitch, since the 1970s rural financial policies had been centred on the supply of subsidized credit by the state-owned agricultural development bank, BANADESA, which lacked transparency and encouraged political intrusion, resulting in high rates of delinquency. In the 1980s, macroeconomic instability resulted in the drying up of long-term
finance, while the enactment of the Caribbean Basin Initiative led to the promotion of non-traditional exports using traditional rediscount lines of credit. In the 1990s, stabilization and structural adjustment policies led to a reduction of the preferential lines of credit and to the consolidation of FONAPROVI, which channelled donor funds to the rural areas and other sectors. The United States Agency for International Development (USAID) and other donors promoted the formation of several microfinance organizations and networks, including Covelo.

A milestone in the promotion of rural financial deepening was the approval, in April of 1992, of the Law on the Modernization and Development of the Agricultural Sector. This legislation allowed the creation of rural savings and loan organizations (cajas rurales de ahorro y crédito). Throughout most of the 1990s, several projects, including those financed by the International Fund for Agricultural Development (IFAD), promoted the creation and operation of these cajas rurales. They were set up according to diverse operational models, at a time when the regulations governing their establishment and operation had not yet been approved.

After Hurricane Mitch, the goals of policy were redirected to respond to liberalization and deregulation, national reconstruction and transformation, and poverty reduction. The new policies defined visions and actions frequently at odds with each other, but with five main common objectives, namely: (i) poverty reduction, with a strong welfare flavour; (ii) development of the agrifood production sector, while ignoring non-agricultural activities; (iii) economic recovery; (iv) environmental sustainability; and (v) citizen involvement. All rural development and agrifood policies have identified credit as a key mechanism in launching productive activities. FONADERS (Sustainable Rural Development Fund) disburse project funds via three channels: (i) direct project financing; (ii) setting up trusts; and (iii) funds transferred by means of agreements and/or contracting. These channels are outside the regulated financial sector, creating distortions in the development of rural financial markets.

While there are no specific policies for the promotion of rural finance, the existing regulatory frameworks influence the provision of financial services for the rural sector through the categorization of a higher risk for farming activities, the legislated cancellation of agricultural debt, and the financing of production by state agencies.

Several features of the general policy framework and specific regulatory frameworks for finance, rural development, and the environment relate to the core theme of the study:

- The policies for the regulation of financial transactions have failed to take into consideration the specific requirements of rural areas.
- Rural development policies are centred on regulating structures and on creating a diverse range of offices, programmes and operational units at the central level, the operation of which lacks a proper territorial approach.
- Rather than on a financial sector approach, the focus is on operating credit funds. This offers room to manoeuvre to programmes and projects that concentrate on channelling funds but that make very little effort to regulate transactions, in order to decrease risk and increase impact.
- Environmental policies have no operational links with financial policies.

Whereas aggregate financial policies are making significant progress in Honduras towards organizational linkages and harmonization, through the development of prudential regulation and the analysis of risk, rural development policies are consolidating the central
management of structures, with a marked tendency to channel resources without regard for consistency with the requirements of financial development.

Debt cancellation trends

The Honduran financial system has been in crisis since Hurricane Mitch, because of low loan recovery rates resulting from substantial losses in the agricultural sector, moral hazard, and political economy forces. Agricultural loans represented 21 per cent of the credit portfolio in the formal banking system in 2000. Total delinquency rates rose from 17 per cent in 1998 to 24 per cent of the portfolio in 1999.

To address these problems, debt-relief mechanisms – chiefly for the agricultural sector – have been designed, including Velastequí (2003):

- interest-rate relief, for reactivating and readjusting outstanding loans and transactions in default;
- relief on the borrowed principal;
- loan guarantees;
- establishment of a credit line in BANADESA;
- issue of bonds by FONAPROVI;
- constitution of a coffee trust;
- discount on the nominal value of loans acquired.

The banks have played a key role in operating these mechanisms, as they have powers to determine which producers to benefit. Many borrowers with past due transactions have had problems in obtaining new loans, as the banks have been reluctant to lend in cases of evident moral hazard. Already by 2002 there was a 66 per cent decline in the volume of new loans from the banking sector. According to the data analysed by Velasteguí, those who have benefited the most from the legislative decrees are producers with access to banking, which has excluded small-scale agricultural producers from these benefits. The debt cancellation process has had three main consequences: (i) there has been unfair competition with the recently regulated non-bank financial sector; (ii) the benefits of debt write-offs for certain groups have heavily undermined the overall willingness to repay; and (iii) lack of familiarity with the operating mechanisms has given rise to confusion.

José María Covelo Foundation

This section describes the set of linkages and alliances (financial and non-financial) forged by the José María Covelo Foundation between 1991 and today. The analysis distinguishes the following three phases:


This phase covered the period from 1991 to 1995, and it is characterized by the start-up of the Foundation and the forging of backward and forward links with an array of partners. With its origins as a micro small and medium enterprise (MSME) development support programme within the National Industry Association (Asociación Nacional de Industriales, ANDI), the José María Covelo Foundation was founded officially in March of 1991 by a group of entrepreneurs with the economic support of USAID as a second-tier financial organization. At the time of its creation there was no mechanism for providing specialized financial support to the MSME sector. Today strong affinity ties remain between the Foundation and the ANDI,
as many of the Foundation’s creators are members of this business association. In fact, today Covelo and the ANDI share the same office building in Tegucigalpa.

During this initial phase, Covelo established **backward financial linkages** with several international cooperation agencies. With the goal of developing a market for financial services for MSMEs, several donors channelled funds to eligible private development financial organizations (PDOs) through the Foundation’s second-tier facility. Today, the Covelo Foundation has expanded its partner base by establishing **financial linkages** with several private, Honduran and international banks as well as development cooperation agencies, which include: the Central American Bank for Economic Integration (BCIE), a regional bank for MSME funding; the Government of Finland, for the administration of a forest project fund; BANHPROVI, a second-tier government bank with rediscount lines of credit for PDOs; and four domestic banks.

In addition to successfully creating financial linkages with the international cooperation community to source funding during this early period, the Foundation created **forward linkages** (financial and non-financial) with first-tier organizations, PDOs. The Foundation focused its activities on building the institutional and business capacity of the major PDOs as well as providing them with bulk loans to expand their sources of funds. During this stage, the Foundation designed indicators of performance and encouraged PDOs to institute a program of self-regulation in an effort to monitor and compare their progress vis-à-vis their peers. In essence through this process, the Covelo Foundation played the role of a substitute supervisory agency.

Over time, the Foundation’s technical assistance and financial support connections grew from an initial 6 organizations in 1991 to 9 in 1995 and 18 organizations in 2003. The portfolio of loans to PDOs rose from US$6.1 million in 1995 to US$78.7 million in 2003. The evidence suggests a prudent initiation of the phase of second-tier activities, with a focus on first developing the PDO capacity to self-regulate, as a mechanism for ensuring that member organizations perceived themselves as operating in the financial services market and for getting away from earlier welfare-based visions and practices. Once this approach allowed a successful deepening of the market, Covelo’s financial transactions began to grow more rapidly.

**Phase II: Market deepening and regulation (1995–2003)**

The second phase could be designated as one of financial market deepening and the achievement of formal microfinance regulation. During this phase, the market for the Foundation’s second-tier financial services was deepened by significantly increasing the number of PDOs served and, consequently, the number of clients reached, the number of loans disbursed, and the size of their portfolios. Noteworthy was the significant female participation rate (over 71 per cent of the clients between 1995 and 2003). This represented an evolution from the original affinity linkage with the industrial sector towards a **gender** approach centred on female capabilities in the development of MSMEs. At the same time, the financial linkages grew, allowing an increasing trend in the total portfolio. By 2003, the number of clients and the credit portfolio had grown significantly since 1996 (Table 1).

### Table 1 Covelo. Evolution in loans to PDOs

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<tbody>
<tr>
<td>Active clients</td>
<td>33,011</td>
<td>43,576</td>
<td>52,319</td>
<td>65,914</td>
<td>66,313</td>
<td>74,701</td>
<td>122,411</td>
<td>119,371</td>
<td>119,753</td>
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</table>
Another factor that led to Covelo’s financial market deepening to the MSME sector during this phase was the start-up of its direct credit programme – at the first-tier using the solidarity group methodology. The effort was geographically centred on the main markets of Tegucigalpa. As the programme was consolidated, the Foundation expanded its outreach to San Pedro Sula, the country’s industrial city, as well as some medium-sized towns and gradually to less developed districts and neighbourhoods.

The numbers of clients linked to the first-tier transactions increased significantly, about 50-fold from 1993 to 2003. The value of the loans disbursed grew even faster during the period (Table 2). Given the Foundation’s affinity, its branches have a major presence in the ToD and its first-tier continues to be mostly an urban operation. From the perspective of its first-tier activities, therefore, Covelo has contributed little to rural financial deepening. The exceptions, of course, have been the second-tier operations of Covelo involving the rural NGOs HDG and PILARH.

### Table 2 Evolution of credit flows at the Fundación Microfinanciera Covelo (first-tier program)

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<tbody>
<tr>
<td>Active clients</td>
<td>292</td>
<td>3,810</td>
<td>6,599</td>
<td>6,344</td>
<td>8,086</td>
<td>9,870</td>
<td>12,556</td>
<td>13,227</td>
<td>16,441</td>
<td>14,407</td>
<td>14,902</td>
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<tr>
<td>Male clients</td>
<td>32</td>
<td>1,829</td>
<td>2,990</td>
<td>2,874</td>
<td>2,537</td>
<td>2,723</td>
<td>3,706</td>
<td>3,952</td>
<td>4,684</td>
<td>4,022</td>
<td>NA</td>
</tr>
<tr>
<td>Women clients</td>
<td>260</td>
<td>1,981</td>
<td>3,609</td>
<td>3,470</td>
<td>5,549</td>
<td>7,147</td>
<td>8,850</td>
<td>9,275</td>
<td>11,757</td>
<td>10,385</td>
<td>NA</td>
</tr>
<tr>
<td>Number of active loans</td>
<td>70</td>
<td>730</td>
<td>1,230</td>
<td>1,600</td>
<td>3,541</td>
<td>3,097</td>
<td>6,105</td>
<td>6,820</td>
<td>9,550</td>
<td>8,410</td>
<td>8,403</td>
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<tr>
<td>Number of loans disbursed^a</td>
<td>304</td>
<td>8,670</td>
<td>21,705</td>
<td>20,488</td>
<td>28,114</td>
<td>40,736</td>
<td>26,774</td>
<td>29,099</td>
<td>33,844</td>
<td>31,918</td>
<td>12,994</td>
</tr>
<tr>
<td>Value of loans disbursed^b</td>
<td>83</td>
<td>3,630</td>
<td>5,355</td>
<td>8,161</td>
<td>9,645</td>
<td>12,210</td>
<td>15,580</td>
<td>16,186</td>
<td>17,413</td>
<td>14,878</td>
<td>6,893</td>
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^a As of April.
^b Thousands of US$, annual total
^c As of June

Source: José María Covelo Foundation – FUNDASIN. 2005.

Hurricane Mitch and the reconstruction efforts that followed influenced the Foundation’s links with the international community and the Honduran government. Because
of its well-established reputation in building sustainable ties with first-tier PDOs, the government called upon Covelo to assist in its reconstruction efforts, especially in channelling funds to the MSME sector post-disaster. These circumstances led to a deepening of Covelo’s relationships with the government, the international cooperation agencies, and the PDOs as well as directly with their clients via their first-tier operations. All indicators of portfolio growth and efficiency confirm an exceptionally dynamic performance through the first- and second-tier operations, as summarized in Table 2 and Table 3, respectively.

**Table 3 Financial evolution in PDOs reached from the Covelo second-tier level**

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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>6,287</td>
<td>8,038</td>
<td>10,392</td>
<td>14,085</td>
<td>18,913</td>
<td>27,123</td>
<td>48,833</td>
<td>43,295</td>
<td>39,860</td>
<td></td>
</tr>
<tr>
<td>Total portfolio</td>
<td>4,820</td>
<td>7,359</td>
<td>7,366</td>
<td>10,869</td>
<td>13,956</td>
<td>19,946</td>
<td>38,328</td>
<td>36,975</td>
<td>32,623</td>
<td></td>
</tr>
<tr>
<td>Total net worth</td>
<td>2,746</td>
<td>4,380</td>
<td>5,294</td>
<td>6,694</td>
<td>8,002</td>
<td>8,282</td>
<td>12,066</td>
<td>27,154</td>
<td>20,592</td>
<td>20,897</td>
</tr>
<tr>
<td>Operating income</td>
<td>1,286</td>
<td>2,409</td>
<td>3,257</td>
<td>4,416</td>
<td>5,211</td>
<td>6,018</td>
<td>5,967</td>
<td>15,874</td>
<td>15,368</td>
<td>5,466</td>
</tr>
<tr>
<td>Operating costs</td>
<td>1,354</td>
<td>2,466</td>
<td>2,769</td>
<td>3,905</td>
<td>5,013</td>
<td>6,043</td>
<td>5,746</td>
<td>13,744</td>
<td>13,728</td>
<td>4,689</td>
</tr>
<tr>
<td>Operating income</td>
<td>-68</td>
<td>-57</td>
<td>489</td>
<td>510</td>
<td>198</td>
<td>-25</td>
<td>221</td>
<td>2,130</td>
<td>1,640</td>
<td>777</td>
</tr>
<tr>
<td>Financial self-sufficiency (%)</td>
<td>95</td>
<td>97.7</td>
<td>117.6</td>
<td>113.1</td>
<td>104</td>
<td>114.4</td>
<td>103.1</td>
<td>115.7</td>
<td>111.8</td>
<td>116.6</td>
</tr>
<tr>
<td>Economic self-sufficiency (%)</td>
<td>93.1</td>
<td>74.3</td>
<td>99.6</td>
<td>94.0</td>
<td>93.9</td>
<td>107.7</td>
<td>95</td>
<td>101.7</td>
<td>102.7</td>
<td>102.8</td>
</tr>
</tbody>
</table>

*As of April  
Source: FUNDASIN.

This influence and Covelo’s linkages with international cooperation agencies, combined with the credibility of ANDI as a sectoral representative and its effectiveness in helping with post-Mitch reconstruction efforts, created a special relationship with the Honduran National Congress during this period. Building on this, the strategic governing bodies of the Foundation emphasized prudential regulation as a key mechanism for organizing the market, facilitating access to funds from the second-tier institutions and, primarily, guaranteeing lawfulness, transparency, and the security of transactions. Prudential supervision was seen as the key to strengthening the viability and sustainability of financial PDOs.

Using its reputational capital gained over the years, the Foundation effectively promoted the negotiation of a legal framework for prudential regulation, which culminated in the approval of the Law on Private Development Finance Organizations (Decree No. 229-2000, published in February 2001). Many observers describe the Foundation’s role as a multiplier and impact disseminator and point out that this link with the National Congress can be characterized more accurately as a pro-regulation alliance. However, in the eyes of others, there was pressure on the PDOs to be regulated that did not spring from financial sustainability objectives. Rather, the proposed legal framework was seen as having mutated into an effort to promote the Foundation’s second-tier role.
In summary, during the first two phases of its evolution, the Foundation underwent transformations in its linkages, which stemmed from internal questions about its operations, external demands from the PDOs in the Network, and challenges raised by the environment. Figure 1 summarizes the sources of change, the linkages, and the actors involved. The time came in 2003 (during the post-Mitch period) for rethinking and redesigning its structure by seeking a new institutional strategy.

**Phase III:** Organizational, reflection, investment and readjustment for change (January 2003–onwards)

Starting in 2003 (two years after the Law was approved), the Covelo Foundation began a period of organizational reflexion and readjustment. The changes made were influenced by the following debates and initiatives that were occurring in the country at the time:
• the debate about the Poverty Reduction Strategy, which included a major microenterprise development component;
• an initiative of the Superintendence of Banks to empower and strengthen PDOs; and,
• a trend among international cooperation agencies to make rural sector development a top priority.

In an effort to better position itself to respond to these trends and to the needs of its partners and clients, the Covelo Foundation made the following major changes during this period:
• the transformation of the José María Covelo Foundation into a holding company in charge of defining the overall strategic vision of the Grupo Financiero Covelo, which includes six service organizations (see Figure 2);
• the separation of its first and second-tier operations, with the creation of the Fundación Microfinanciera Covelo at the first-tier and the Fundación Aquiles Samuel Izaguirre (FUNDASIN) at the second-tier;
• the uncoupling of the network of associated PDOs, giving the network its own identity, by creating the MICROH Network; and,
• the development of a special agricultural programme in an effort to deepen the supply of financial and nonfinancial services in rural areas.

Figure 2

**STRUCTURE OF GRUPO MICROFINANCIERO COVELO**

Intra- and extra-group linkages** cultivated throughout the three phases became an integral part of the Group’s strategy for deepening financial markets for the MSME sector. In its current form, the Group’s strategic vision is centred on intra-group linkages between the José María Covelo Foundation – which provides financial, human resources, administration, systems, marketing – and organizational services to the six service organizations of the
Group. In addition, the second-tier level (FUNDASIN) offers technical assistance and funding to PDOs and carries out risk analysis and project administration activities. At the first-tier level, Fundación Microfinanciera Covelo is the most prominent organization, with financing activities implemented via regional management sub-boards, and is in charge of development of credit technologies, loan recovery, and risk management.

In addition, the Grupo Financiero Covelo has created extra-group linkages with multiple external actors that can be categorized as follows: market-deepening linkages (focusing especially on the rural sector), linkages for the management of knowledge and training, linkages for the management and channelling of funds, and policy-influence linkages.

Market-deepening linkages for rural finance
The Grupo Financiero Covelo, in an effort to deepen the supply of services in the rural areas, has forged partnerships to develop a special agriculture programme through its first-tier operations. Alliances and linkages are being created with the Financial Transactions Reports Analysis Centre (FINTRAC), the China/Taiwan Mission in Honduras, El Zamorano, the Honduran Foundation for Agricultural Research (FHIA), and a few agrotrading enterprises in an effort to extend technical assistance to clients (Gonzalez-Vega et al., 2006).

In addition to this, Covelo via its first-tier operations has implemented a guarantee fund, contributed by USAID, to cover the risks associated with the agricultural sector. Microfinanciera Covelo provides technical assistance on the client’s business plans and financial requirements. The program is being operated in some rural areas as a pilot, with intentions to extend it to traditional livestock production areas. These linkages reveal a qualitative leap forward from the mostly urban approach of Covelo’s first-tier operations in the past. It suggests cautious optimism about its potential for deepening rural financial markets. Figure 3 shows the gradual evolution of disbursements.

Figure 3 Disbursements of the Agriculture Programme of Microfinanciera Covelo (US$)

Funding linkages
The management and channelling of funds have resulted in the Group’s main forward and backward linkages. On the one hand, the organization mobilizes funds for on-lending to MSMEs through the linkages with international cooperation agencies and financial backers. On the other hand, the organization channels these funds through its linkages with first-tier organizations via FUNDASIN, which currently caters to 18 PDOs and exhibits a growing
portfolio as shown previously in Table 1. Both HDH and PILARH participate in this programme. Their officers stated that this is an important linkage in the financing of their activities. They indicated that the flexibility of the services assures them of sufficient funds to respond to the demand from their clients. These linkages are examined in detail in the next section of this chapter.

**Policy-influence linkages**

The strategic and management teams at Covelo have maintained close, continuing, and direct linkages with policymakers, with the objective of influencing decisions about microfinance issues. They have focused mostly on MSMEs and the access to assets required for their upgrading. The foundation for their strategy has been the desire to strengthen this segment of the financial system through regulation. Their most conspicuous achievement has been the value added in the process of negotiating the Law.

There have been, as well, doubts and objections to this role. Some observers, particularly among those especially concerned with rural development, have lamented a narrow financial perspective and would have liked to see the Foundation involved in promoting greater coherence between financial policies and policies for promoting the farming sector. The concerns are only partially valid. The emphasis on regulation has induced a healthy concern in meeting targets conducive to sustainability, through the implementation of information systems, management improvements, and internal linkages, to enable these PDOs to operate as financial entities. Thus, the majority, including the Foundation, have opted to separate their production support activities and have placed them in a parallel PDO. Some observers also fear that this distancing between production strategies and finance may perpetuate the contradictions responsible for backwardness in the rural areas in Honduras. Table 4 reports on some of the perceptions observed during the interviews with a broad range of actors.

**Table 4** Decision-makers’ perceptions of the role of Covelo

<table>
<thead>
<tr>
<th>Issue</th>
<th>Perception</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual impact</td>
<td>Covelo’s steady and sustained effort is the key to its participation at the strategic levels of policymaking.</td>
</tr>
<tr>
<td></td>
<td>Covelo and the Honduran National Congress formed an alliance and managed to push through legislation that not everyone supported.</td>
</tr>
<tr>
<td></td>
<td>Covelo is the sector’s political arm. Through its transformations, the Group has been strongly identified with the MSME sector. The Group is politically effective.</td>
</tr>
<tr>
<td></td>
<td>Covelo is able to play a major role in legislation because it receives funds and assistance and influences where these resources are channelled.</td>
</tr>
<tr>
<td>Openness to the issue</td>
<td>Covelo is paving the way for non-profit organizations and inspires credibility and confidence.</td>
</tr>
<tr>
<td></td>
<td>It is a strong institutional arm for international organizations, which see it as a trustworthy tenderer that can channel funds to the first-tier level.</td>
</tr>
<tr>
<td></td>
<td>Although the Network is important, it has been demonstrated that it does not have to be housed in a second-tier organization.</td>
</tr>
<tr>
<td></td>
<td>It represents a framework of reference for designing strategies and financial programmes targeted at the sector.</td>
</tr>
<tr>
<td>Rural financial services</td>
<td>The microfinance issues must be separated from rural financial services.</td>
</tr>
<tr>
<td></td>
<td>The rural sector is the sector most penalized by policies.</td>
</tr>
<tr>
<td></td>
<td>Covelo’s aim was to pave the way in order to demonstrate that the first-tier is...</td>
</tr>
</tbody>
</table>
feasible and profitable. Now, it is attempting to do the same with the agricultural credit programme.

Source: Interviews with decision-makers from the National Congress, the Covelo Foundation, and the CNBS

The decision-makers interviewed see these policy-influence linkages as elements conducive to sustainability. However, for those at the first-tier level, Covelo’s linkages with the policymakers are viewed with caution. They point out that the organization plays a dual role (with operations at the first-tier and the second-tier). That is, the Group is perceived as a competent authority and an able financier and, at the same time, as an agency in the position to influence jurisdiction issues. Thus, they claim that these linkages ensured that regulation be delegated to the Covelo Group. This dual role may complicate any strategy of expansion into rural financial markets, where Covelo would be competing with the PDOs.

Moreover, representatives of the first-tier level agree that Covelo’s proactive role in encouraging regulation has not been accompanied by the development of a regulatory framework by the Superintendence of Banks, CNBS, that reflects appropriate knowledge of key features of the rural sector. At the same time, they feel that Covelo has not been sufficiently proactive in condemning legislation about debt cancellation in the agricultural sector, in reflection of a focus on its mostly urban interests. However, at the Group level, there is a clear and widespread perception that this policy has undermined willingness to pay. Insufficient lobbying on this issue may have reflected a failure to gauge the implications for the rural sector. With the new priorities on a ‘return to a rural approach’, their scant influence on rural policies is being felt.

Linkages with local rural operators: the case of HDH and PILARH

The Covelo Group currently maintains linkages – from the second tier (FUNDASIN) – with 18 organizations. Two of these organizations – HDH and PILARH – are involved in rural financial deepening, by offering services adapted to the areas in which they operate.

Linkages between Covelo and HDH

The linkage with Covelo began in 1990–1991, when HDH sought to expand its portfolio toward microenterprises in manufacturing, commerce and agro-industry. The linkage provided funds and free training and created a win-win situation. Pressures from Covelo led to the adoption of self-regulation, which became a positive asset when HDH opted for prudential regulation in the 1990s. This self-regulation linkage involved the joint management of information and it led, in 1997, to the adoption of the solidarity group methodology.

One weakness in the initial linkage was the limitations of the Covelo advisors working in the region to effectively monitor and advise HDH. This was perhaps explained by the Foundation’s tradition of working in urban areas, while its staff recruitment systems gave no special consideration to the rural sector. HDH’s funding linkage with Covelo increased client outreach and the portfolio (Table 5). At the same time, Banco de Occidente, with its more flexible rural approach, has kept a line of credit open with HDH through today.

**Table 5 Consolidated data: HDH**

<table>
<thead>
<tr>
<th>Variable</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Members</td>
<td>2,028</td>
<td>2,863</td>
<td>4,657</td>
<td>7,085</td>
</tr>
<tr>
<td>% individual men</td>
<td>36</td>
<td>38</td>
<td>41</td>
<td>43</td>
</tr>
<tr>
<td>% individual women</td>
<td>64</td>
<td>62</td>
<td>59</td>
<td>57</td>
</tr>
</tbody>
</table>
Taking 2001 as the base year, there has been an increase in client outreach. The number of male clients has grown rapidly (60 per cent per year). The number of loans increased 123 per cent from 2001 to 2004, with microenterprise credit absorbing most of the funds, whereas the share of agriculture fell. The average loan amount declined from US$796 in 2001 to US$509 in 2004.

In the last two years a strong linkage has emerged with Banco de Occidente which, like HDH, operates in north-western Honduras. HDH has also received funding from donor agencies (one-fifth of the total) Net operating income switched from losses in 2001 to profits of US$ 191,600 in 2004, as a result of increases in the number of clients and the loan portfolio, with total income growing 21 per cent compared to12 per cent per year for total expenditures (Table 6).

Table 6 HDH. Statement of income and expenditures (thousands of US$)

<table>
<thead>
<tr>
<th>Account</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income from interest and loan</td>
<td>520</td>
<td>563</td>
<td>745</td>
<td>975</td>
</tr>
<tr>
<td>fees</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total income</td>
<td>564</td>
<td>613</td>
<td>769</td>
<td>989</td>
</tr>
<tr>
<td><strong>Expenditures</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest and loan charges</td>
<td>81</td>
<td>43</td>
<td>43</td>
<td>107</td>
</tr>
<tr>
<td>Provision for bad debts</td>
<td>126</td>
<td>131</td>
<td>94</td>
<td>72</td>
</tr>
<tr>
<td>Administrative costs: staff</td>
<td>266</td>
<td>281</td>
<td>318</td>
<td>439</td>
</tr>
<tr>
<td>Other administrative costs</td>
<td>124</td>
<td>117</td>
<td>171</td>
<td>221</td>
</tr>
<tr>
<td>Total expenditures</td>
<td>598</td>
<td>573</td>
<td>626</td>
<td>839</td>
</tr>
<tr>
<td><strong>Net operating income</strong></td>
<td>-35</td>
<td>40</td>
<td>143</td>
<td>192</td>
</tr>
<tr>
<td>Non-operating income</td>
<td>123</td>
<td>29</td>
<td>29</td>
<td>32</td>
</tr>
<tr>
<td>Non-operating expenses</td>
<td>70</td>
<td>55</td>
<td>14</td>
<td>15</td>
</tr>
<tr>
<td>Other non-operating revenues</td>
<td>210</td>
<td>232</td>
<td>238</td>
<td>311</td>
</tr>
<tr>
<td>Non-operating expenses</td>
<td>158</td>
<td>112</td>
<td>120</td>
<td>177</td>
</tr>
<tr>
<td><strong>Consolidated earnings</strong></td>
<td>70</td>
<td>134</td>
<td>277</td>
<td>302</td>
</tr>
</tbody>
</table>

N/A: Not applicable

Source: Hermandad de Honduras, 2005
The main lessons learned from the linkage with Covelo Foundation are:

- The leverage of funds to secure technical assistance for institution building has been crucial, and in several cases participation in the Covelo Network opened the door to cooperation from USAID and the Inter-American Development Bank (IDB).
- The Foundation’s influence on the Law has strengthened the Mao’s position opposite the Superintendence of Banks.

Funding from the second-tier programme was crucial, especially during the pre-Mitch period, when it was difficult for MFOs to access funds. Now, with regulation, easier access to funds means that MFOs have sources alternative to FUNDASIN. Even though the Covelo linkage has been quite productive, there are a number of contradictions:

- The duality of its first and second-tier operations means that the Group handles client information and operates in the same area as the MFO partners of its second-tier operation, creating a certain level between the two organizations.
- As FUNDASIN operates a line of credit with the Central American Bank of Economic Integration, the reports for this programme require a breakdown of clients. This may also create conflicts of interest and possibility of double counting.
- The fact that HDH works with FUNDASIN, clients have difficulty understanding the different roles of the first-tier and second-tier operations of the Covelo Group.
- The Group uses information about the portfolios of the MFOs in its negotiations with external partners. This causes conflicts because, as a regulated organization, HDH also seeks funds, sometimes from the same partners.

The issues related to information and the duality of the first and second-tier operations may introduce constraints on rural financial deepening. HDH views FUNDASIN as just another actor in its list of financial backers. As HDH is regulated, it feels that it can negotiate its own funding.

**Forward alliances of HDH**

HDH has a series of strategic alliances and relationships with grassroots groups, international donors, and formal financial intermediaries. This section focuses on the first type of alliances, given the direct impact and potential positive spillovers of the social interventions on the financial component of HDH.

a. **Cajas rurales.** The *cajas rurales* are small associations found frequently in rural Honduras, which finance communal development projects as well as individual ventures. They are a complement to public investment in areas such as health, education, strengthening of local organizations, enterprise development, and the funding of individual production projects. All have been legalized as *empresas asociativas campesinas* (peasant associative enterprises) and operate under the umbrella of the rural economic committees, a second-tier organization.

The *cajas* are created (or strengthened) by the social division of HDH and are funded by the microfinance unit. The objective is threefold: to promote grassroots development, improve infrastructure and living conditions in rural areas, and create a base of potential credit clients. This is achieved through integrated support consisting of institutional strengthening, technical assistance, and funding.
The *cajas* consist of groups of 12–34 members who receive, as seed capital, a loan from HDH, at zero interest rate and a five-year term. In some cases, the seed capital is not enough, so the *cajas* request working capital or loanable funds. This funding requires the member’s joint liability or a mortgage.

As of December 2005, HDH had transactions with 56 *cajas rurales*, 20 established directly by Hermandad, and the remaining 36 strengthened by this organization. They had almost 1,000 members, the majority with agricultural activities, and others engaged in communal or collective projects such as grocery stores or agricultural and veterinary stores. The *cajas* are very rural, usually located in remote regions, accessible only by foot and reachable only during the dry season; 70 per cent have agricultural activities. There are *cajas* with only men, only women, or mixed membership; the latter reveal the best performance, for unknown reasons.

b. **PACTA.** This is a land project, sponsored by the World Bank and implemented by FAO. It works with formal and informal organizations of farmers without access to arable land, who are contacted through the national organization of the Lenca Indians (ONILH), agro industrial cooperatives and municipal corporations. The project hires the social unit of HDH to empower farmers and provide technical assistance, including the preparation of feasibility studies for acquiring land.

The farmers negotiate directly with the owner of the land, and when a fair agreement is reached, the project is presented to a financial organization, which may be the financial unit of Hermandad, now that the two areas – social and financial – have been separated. HDH will fund up to 150 per cent of the cost of the land, for both investment and production purposes. The project has supported almost 200 farmers, with around US$2.5 million.

c. **Alliances with indirect financial impacts.** There are several strategic alliances in which HDH has been heavily involved, because of their overall positive impact on the communities and as a means to improve the creditworthiness of current and potential clients. Some of these linkages are:

   (i) **UMA.** A new Reforestation Law was passed in 2000, as a consequence of hurricane Mitch, with heavy lobbying from HDH. One of its features is the creation of *Unidades Municipales Ambientales* (UMAs), in charge of fire control and reforestation. HDH has supported and actively promoted the creation and operation of UMAs in the five municipalities where it operates.

   (ii) **Health projects.** These are ‘basic health packages’ that reach 14 municipalities and 90 communities. HDH is involved in two municipalities, benefiting an estimated 28,000 people and improving the health conditions of its borrowers.

   (iii) **Adult education.** HDH’s involvement in this project stems from the great difficulty to find members of *cajas rurales* who can read and write, thus concentrating the participation in the boards of directors in a few people, who after some time abandon the group because of excessive work. The program
involves both adult and preschool education. The project currently operates in 30 different centres, with a total of 240 adults and 360 children.

(iv) **CICAL.** This is a food security project, sponsored by the European Union. A food processing firm owned by 17 partners (mostly women) vacuum-packs fruits and vegetables. HDH helped to establish a value chain that includes production, processing, and marketing. CICAL was supported with training, legal advice, purchase of machinery and tools, greater physical infrastructure, permits, and patents.

(v) **SANA.** To confront the local and central governments’ budget restrictions for improving both drinking water and sanitation infrastructure, the state’s water and sewer agency, SANA, established a joint project with HDH and USAID.

d. **Financial relations.** HDH has linkages with many financial organizations, ranging from private commercial banks (*Banco de Occidente* and *Banco Mercantil*) and international agencies (Inter-American Development Bank, Central American Bank for Economic Integration) to private financial organizations such as Covelo and Oiko Credit. Some of these relationships involve services other than credit, such as deposits, cash managements and transfers, and, in a few cases, technical assistance and institutional strengthening.

HDH executives recommend, before an alliance is implemented, a clear understanding of the extent of the project, its costs and the resources each partner must invest – financial and non-financial. Even for the smallest linkage or joint project there should be a business or strategic plan.

HDH praises the results of the linkages in which it has been involved, many with the technical and financial support of the international donor community. These linkages have allowed it to organize and empower the target population and build social and production infrastructure. They lament that most assistance has been concentrated in areas directly impacted by hurricane Mitch, although all rural areas experienced indirect consequences of the natural disaster. Agencies located in the two largest cities – Tegucigalpa and San Pedro – are not always aware of the problems and challenges faced by isolated rural populations.

**Linkages between Covelo and PILARH**

Although initial efforts date back to 1999, the formal linkage between Covelo and PILARH began in 2001, resulting in the disbursement of funding in 2002. The delay called for a review of the self-regulation process, with monitoring to facilitate the moving up of the rating scale. The appeal of joining the Covelo Network was access to funding, although the trial period provided an opportunity to deepen the linkage in the areas of financial and organizational management. The funding linkage started with US$120,000, the currently line of credit line is US$270,000. In addition, PILARH has credit lines from other entities for US$400,000.

<table>
<thead>
<tr>
<th>Table 7 PILARH. Consolidated data</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Indicator</strong></td>
</tr>
<tr>
<td>Members</td>
</tr>
<tr>
<td>Category</td>
</tr>
<tr>
<td>----------------------------------</td>
</tr>
<tr>
<td>Men (%)</td>
</tr>
<tr>
<td>Women (%)</td>
</tr>
<tr>
<td>Groups (%)</td>
</tr>
<tr>
<td>Borrowers</td>
</tr>
<tr>
<td>Total assets (thousands US$)</td>
</tr>
<tr>
<td>Bank deposits (thousands US$)</td>
</tr>
<tr>
<td>Loans outstanding (thousands US$)</td>
</tr>
<tr>
<td>Agricultural portfolio (%)</td>
</tr>
<tr>
<td>Microenterprise portfolio (%)</td>
</tr>
<tr>
<td>Bank indebtedness (thousands US$)</td>
</tr>
<tr>
<td>Total loans (thousands US$)</td>
</tr>
<tr>
<td>Donor funds (thousands US$)</td>
</tr>
<tr>
<td>Capital without donations (thousands US$)</td>
</tr>
<tr>
<td>Return on assets (%)</td>
</tr>
<tr>
<td>Return on equity (%)</td>
</tr>
</tbody>
</table>

N/A: Not applicable

Source: PILARH

Since 2001, linkages with clients have been deepened, with a 133 per cent increase in the number of clients by 2004, although this number declined in 2004. Male participation rose from 61 per cent in 2001 to 70 per cent in 2004. Average loan size fell from US$376 in 2001 to US$253 in 2004. (Table 7).

Funding increased at an average annual rate of 17 per cent, with funds from government projects taking the greatest share (72 per cent of the growth). Donor funds declined gradually since 2001. PILARH is deepening its linkages with public agencies but not with the financial sector. The organization financial losses reflected the drop in the numbers of members and total loans in 2004 and high staff costs (PILARH spends US$0.51 for every dollar lent), (Table 8).
Table 8 PILARH. Statement of income and expenditures (thousands of US$)

<table>
<thead>
<tr>
<th>Account</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income</strong></td>
<td></td>
</tr>
<tr>
<td>Income from interest and loan fees</td>
<td>0.3</td>
</tr>
<tr>
<td>Income from other related financial services</td>
<td>3.4</td>
</tr>
<tr>
<td>Investment income</td>
<td>13.2</td>
</tr>
<tr>
<td>Total income</td>
<td>271.3</td>
</tr>
<tr>
<td><strong>Expenditures</strong></td>
<td></td>
</tr>
<tr>
<td>Interest and loan charges</td>
<td>59.8</td>
</tr>
<tr>
<td>Provision for bad debts</td>
<td>8.9</td>
</tr>
<tr>
<td>Administrative costs: staff</td>
<td>490.0</td>
</tr>
<tr>
<td>Other administrative costs</td>
<td>6.7</td>
</tr>
<tr>
<td>Total expenditures</td>
<td>565.5</td>
</tr>
<tr>
<td>Net operating income</td>
<td>-294.2</td>
</tr>
<tr>
<td>Cash donations</td>
<td>278.0</td>
</tr>
<tr>
<td>Other non-operating income</td>
<td>218.9</td>
</tr>
<tr>
<td><strong>Consolidated earnings</strong></td>
<td>5.7</td>
</tr>
</tbody>
</table>

Source: PILARH

In 2004, PILARH joined the MICROH Network, fearing that it would no longer have access to FUNDASIN’s funding. The organization sees this linkage as a way of gaining prestige and national and international recognition. A policy of expansion calls for doubling the portfolio’s growth rate, through increasing loan sizes. Each adviser will handle 350 clients, rather than 250 to 300. PILARH’s confidence is based on its centralized accounting, risk management, and a collection system closely linked with AMPRO. It hopes to strengthen ties with existing clients rather than to increase the breadth of outreach.

At first, PILARH perceived self-regulation as an excessive burden, but the process has become routine in the organization. Self-regulation parameters are still being revised and the Superintendence has developed a monitoring process for those willing to become eligible for self-regulation. The linkage with Covelo focuses on promoting regulation among unregulated organizations.
Forward alliances of PILARH

Despite its small size (compared to HDH), PILARH shows an interesting set of strategic alliances. The linkage with AMPRO matters because it is an effort developed and implemented by PILARH to promote empowerment and funding of production, which provides grassroots groups a participation in PILARH’s decision-making process. Other alliances of PILARH have an indirect impact on its financial component.

a. **AMPRO.** PILARH provides services to individual clients (basically credit) and to groups of clients (credit and non-financial services). In the five regions where it operates, it has created 230 groups, with approximately 4,000 members and an average of 17 associates per group – with outliers of 8 and 30. PILARH provides training, technical assistance, credit, and institutional strengthening. Each group has a board of directors and, in each region, the chairpersons constitute another AMPRO, which can be described as a federation of groups. Each AMPRO has legal status; five form one big AMPRO, also with a board of directors and participation in PILARH’s Assembly. Indeed, of the 23 members of the Assembly, five represent AMPROs. The AMPROs have been established through the cooperation of Trias, a Belgian development organization. The current phase of the project aims at integrating the groups into processes of communal participation and policy dialogue.

b. **INCA.** In order to allow small coffee producers to lower their costs, PILARH and a private partner created this firm, which plans to supply as many services as possible along the value chain. It now includes an agricultural input supplier, a processing plant, a marketing operation, and it is adding a veterinary service. PILARH owns three-fourths of the firm and is hoping that the AMPRO buys-out the shares of the private partner.

c. **DELSAR.** The agency for the development of Santa Rosa (DELSAR) is a joint effort of the local government and civil society. PILARH’s involvement is through an IDB-sponsored project aimed at providing training and technical assistance to a group of 71 microentrepreneurs producing handicrafts (made out of leather, wood, and wrought iron), as well as textiles and traditional food. DELSAR and PILARH cover 30 per cent of the costs of the project.

d. **Escuela Agrícola Pompilio Ortega.** This technical high school and the Regional Centre of the Universidad Autónoma de Honduras have become valuable sources of personnel for PILARH, particularly facilitators working for the social component and credit officers. The NGO allows students to undertake their professional practice there, so it has the chance to test these potential employees before actually hiring them.

e. **Other alliances.** There are several other linkages of PILARH that improve human capital, production opportunities and access to credit. The following stand-out:

   (i) **ASONOG.** This is an association with non-financial programs supporting marginal clienteles.
(ii) **JICATUYO.** This is a project sponsored by the European Union focused on coffee production. It supports groups of producers in their efforts to improve their production and marketing capabilities.

(iii) **Scholarships.** As an incentive for children to stay in school, PILARH provides monthly scholarships of approximately US$17 to children of AMPRO members with a good academic record.

PILARH’s executives believe that strategic alliances are positive as long as there is mutual understanding and good coordination and particularly transparency and trust. The objectives of the organizations involved must be similar, and there should be a complementarity of resources and actions in order to maximize the impact of the project. Coordination is not always easy, as a consequence of lack of personnel. The government does not provide much support, although the target population of the AMROs and, in general, the regions where PILARH operates, reveal the highest levels of poverty.

**Impact of HDH and PILARH linkages with Covelo**

Both organizations have deepened rural financial services significantly, judging by their link with 10,790 clients, representing 3.3 per cent of all producers nationwide and 5.7 per cent of producers in farming regions. There has been dynamism and growth in their portfolios during this decade. HDH has shown an average annual growth rate of 23 per cent in its portfolio and 34 per cent in the number of clients, with loans totalling US$2.5 million in 2004. PILARH had a smaller outreach of 3,785 clients in 2004, and the average annual growth rate of its portfolio was 13 per cent. Its loan portfolio ranged from US$609,648 to US$959,152, while average individual loan size was US$ 253 in 2004.

The linkages continue to have a weak impact on rural financial deepening. The levels of satisfaction and ownership of the linkage with the Covelo Group show that HDH and PILARH highly value the support received in the beginning, both funding and particularly the technical assistance and self-regulation program. Further, they are enthusiastic about the new law sponsored by Covelo. Today, FUNDASIN is considered as one of the funding options, but not the only one. In addition, the functional dualism and overlapping of roles within the Group (first- and second-tier financing) makes both organizations cautious about providing information.

**Lessons learned and conclusions**

Several important lessons for rural financial deepening in Honduras have been learned.

♦ **Factors in the relationship between the Covelo Group and first-tier organizations that explain the deepening of rural financial markets**

The linkage with the Covelo Group originated from funding and self-regulation, based on a microenterprise approach, while the deepening of rural financial services by the organizations stems from their identity with the rural area and specifically with poor clients. The interviews did not show that the linkage had triggered rural deepening or incentives for it. What is clear, though, is that the linkage allowed the organizations to position themselves at the national and international level. Regulation now provides the organizations with direct access to other sources of funds, leading to lower transaction costs, which could allow interest rates to be lowered by eliminating a link in the chain.
The organizations have made major progress in opening up their portfolio of financial backers, which is why their linkage with the Group – and specifically with FUNDASIN – is currently centred on competition. Having become self-regulated (HDH), there is an opportunity to access funds directly. PILARH also considers this to be an added value factor of regulation, over and above the possibility to capture savings.

♦ Risks or constraints the organizations encounter in their linkage with the Covelo Group

The main risk discerned by the organizations is the Group’s dualism of first- and second-tier operations, which shows that its role of jurisdiction could come into conflict with the funding scheme. However, the organizations saw that, during the process of negotiating the Law, a possibility was proposed that the Group could take over regulation. This raises even greater concerns, since this would give the Group the triple role of financial backer, competent authority and regulator, which in market terms would not promote a level playing field.

♦ Client’s perception of the linkages with the organizations

The clients perceive the linkage of identity with the organizations from a central perspective, associated with three factors: flexibility, understanding, and respectful treatment. Thus, technical assistance may play a major role but, unlike in the past, this role would be to work with clients on the basis of their credit history and repayment record, rather than on the demand for credit.

PILARH claims to have learned the key lesson that transaction costs are considerably reduced when the producers are organized around a territorial approach and their organization participates in the institution’s decision-making. In HDH’s case, heavy-handed monitoring, in order to set a precedent in cases of non-payment, is combined with a timely, flexible credit service and respectful treatment. Much of the technical assistance is provided by means of alliances with other actors specialized in this field.

The strategic alliances established with local organizations by HDH and PILARH may well be described as of a development nature. That is, they improve social and production infrastructure, at the same time that they increase human capital, production opportunities, creditworthiness and access to financial services of current and potential clients of the two NGOs. Given the high poverty levels and poor living conditions of the rural areas where they operate, the positive impact of these linkages is enormous.

♦ Regulation as an instrument for deepening rural financial markets, particularly in areas where livelihoods reflect high poverty levels

Regulation has contributed greatly to the organizations becoming specialized in financial services, and control has guaranteed the transformation of management, separating financial from non-financial transactions in each of the two organizations. Since both organizations sprang from a non-financial initiative, this proactive development contributes to deepening rural markets by providing a comprehensive service, including agricultural and microenterprise activities. Interestingly, both organizations have developed differentiated terms and programmes for the agricultural and non-agricultural sectors.

Regulation has not succeeded in linking their financial management approach with the financial system, as rural development policy hopes to promote. On the contrary, debt write-offs, used as instruments of rural development policy, have weakened the willingness to pay being promoted by the financial services of these organizations.
Conclusion

Linkages within the microfinance sector can play a role in poverty reduction by helping to improve the incomes of the poorest sectors, targeting the poorest and most vulnerable groups in the rural areas. This strategy involves three key elements. First, to play a major role, rural microfinance linkages must start to move away from just influencing overall regulation policies towards inclusive rural development policies that consider microfinance and its characteristics as policy instruments. They must begin to break with the mistakes of the past, where financial policies were structurally disconnected from rural development policies. This means that regulators should expand their vision of rural issues (without relaxing the supervision), and rural development policymakers should be linked operatively to a financial system that abandons the traditional welfare-based approach in favour of building stronger livelihoods.

Second, although improving incomes is the first direct and visible effect of microfinance, its ultimate and additional aim is to improve people’s livelihoods, which means successfully triggering linkages and alliances that strengthen not only regulation but also a ‘pro-rural’ vision, which is more than agriculture and more than processing microenterprises.

Third, targeting involves studying the territoriality of rural poverty and, on that basis, determining means of operation, types of service, and activities to forge linkages with clients. Targeting calls for more than just widening the network of agencies in a rural area; instead, the aim should be to find the operational and financial means for deepening markets.
References


