Chapter 10
Partnership to expand sources of funds for rural microfinance in Peru: the case of Confianza
Janina León

Abstract: This study explores the way a regulated microfinance institution in Peru, Confianza, links to external partners to expand its sources of funds. The author discusses the impact of recent microfinance regulation on the opportunities for Confianza to diversify its sources of funds. The author states that, in the Peruvian context, regulation plays a significant role in the type and nature of financial linkages MFIs can engage in. Regulated MFIs, like Confianza, have greater access to funds from international investors, commercial banks and the government backed apex organization, COFIDE, than non-regulated NGOs. For purposes of comparison the author discusses briefly the challenges faced by ARAWIRA, a non-regulated financial NGO, in obtaining funds on a sustained basis.

Introduction

While rural people need access to financial services, the supply of such services in rural areas is extremely limited due to the high costs and risks associated with providing them. In Peru, as well as in other countries, some local organizations are making great strides in expanding access to credit in remote areas due to their informational advantages and innovative lending practices and systems. However, their efforts are often constrained. Unable to mobilize deposits and access external funding on a sustained basis, especially through commercial channels, these organizations have limited resources from which to expand their outreach. Among their efforts to overcome these restrictions, some microfinance institutions (MFIs) have established linkages with the formal financial sector. The main objective of this study is to examine these financial linkages between different financial institutions and how far they helped to expand services provision in rural areas.

This study primarily explores the ways in which a regulated MFI, Confianza, has linked with external partners to expand its sources of funds. The case focuses on Confianza’s organizational type, and, given its type, the potential to diversify sources of funds, operate efficiently and penetrate rural areas. The experience of another another MFI, a non-regulated financial NGO, Arawira, is briefly presented for comparison purposes.

In the sections that follow a brief presentation of the context of Peru is presented, followed by a detailed description of the Peruvian financial system, identifying the main microfinance actors and products. The next section largely examines the experience of the regulated MFI, Confianza, including an analysis of its linkage types, motivations, mechanisms, their role in its institutional capacity strengthening and financial outcomes as well as its outreach performance. A summarized reference to the NGO Arariwa is included to compare both institutions in terms of their linkages impact on rural outreach. The chapter concludes with a presentation on the main lessons learnt, some reflections about possible trade-offs between organizational type and subsequent effects on rural penetration, and the need for further empirical research.
Country context

Peru is located in South America, next to the South Pacific Ocean and bordering Chile, Ecuador, Colombia, Brazil and Bolivia. Its wide geographical diversity allows it to have more than twenty microclimate areas, from temperate to dry desert near the coast, frigid and dry weather in the Andes Mountain, and tropical temperature in the jungle. Peruvian natural resources include mineral and metal (copper, gold, zinc) reserves, ample coastal waters for fishing, and highlands for growing high quality coffee. Agriculture is very heterogeneous, including non-tradable peasant production and larger units producing for exports. The Peruvian economy is largely driven by exports of minerals, textiles, and agricultural products. Given this, the country’s growth is heavily vulnerable to world price fluctuations in copper, zinc, gold, petroleum, coffee and oil, despite public policies to make native industry emerges.

Approximately 27 million people live in Peru (2005 estimate), largely descendents of Spanish settlers and native Inca and pre-Inca cultures. Due to high rural-urban migration that took place from the 1960s through the 1980s, seven out of ten Peruvians live in urban areas. The population density is, on average, 20 people per square kilometer. The population is unevenly distributed, with overcrowding taking place in many urban centres, like Lima, while mountainous regions and jungle areas remain sparsely populated. Microenterprises have multiplied mostly in urban areas, becoming the main source of income for the labor force. For several decades, poverty has been spread along the country, with extreme poverty largely located in rural areas, mostly in the Trapecio Andino area.

Since the dramatic economic conditions of recession and hyperinflation of the 1980s, Peru has experienced a sustained period of macroeconomic growth and recovery during the 1990s and 2000s (see Figure 10.1). With a stable exchange rate, low inflation, low-risk premium on Peruvian bonds, prudent fiscal policies, and an openness for trade, Peru has become an attractive place for foreign investment (CIA Factbook, 2005; Banco Central de Reserva del Peru, 2005).

![Figure 10.1 Peru Macroeconomic Performance 1992-2005](image)

Source: Author’s elaboration, based on Banco Central de Reserva del Peru (2005) and Ministerio de Trabajo, with unemployment data for Lima Metropolitana.

However, economic gains have not been shared by all segments of the population. Although formal employment increased in number during this period, underemployment and unemployment increased more. Statistics also show that approximately 50% of the population has remained poor, with the poorest concentrated in rural areas (CIA Factbook, 2005; Banco Central de Reserva del Peru, 2005).
Financial System and Microfinance in Peru

Financial services in Peru are provided by diverse institutions and agents in the market. By 2005, the Peruvian financial system consisted of 11 commercial banks, 38 regulated MFIs, four government apex and first-tier banks, 13 insurance companies, four pension fund firms and nine other financial institutions. The MFIs include 13 municipal banks (CMACs), 12 rural cajas (CRACs) and 13 EDPYMES (Entidad de Desarrollo de la Pequena y Micro empresa). All regulated financial institutions are under supervision of the Superintendencia de Banca y Seguros (SBS), following regulatory guidelines set by Basel and audited in compliance with internationally accepted auditing standards, having customer deposits backed by their common deposit insurance fund (Superintendencia de Banca y Seguros, 2005).

As expected banks, commercial banks have most of the market share in terms of loans and deposits. Based upon their loan portfolio, Figure 10.2 provides the market participation of regulated institutions: commercial banks count for around 80% of the market, while MFI supply almost 10% of total market when looking at loan portfolios. The picture changes, however, when looking at the sector by number of loan contracts institutions hold. In this way, commercial banks and MFIs serve 50% and 25% of the market, respectively. Thus, as one would expect, large loans are common among commercial bank clientele, while small loans are mostly issued by MFIs.

Figure 10.2 Regulated Financial Institutions and their Loan Market Share

Commercial banks and MFIs target different loan clientele. As shown in the Figure 10.3: commercial banks lend for business, housing and consumption, accounting for almost 75% of their loan clientele. MFIs, on the other hand, primarily lend for microenterprise development and personal consumption, roughly 80% of the loans they grant. Still commercial banks are the main suppliers of loans for business and microenterprise development in the market, in terms of loan volume.

Figure 10.3 Regulated Financial Institutions by Type of Loan Clientele
Several regulatory and macroeconomic events have shaped the current MFI industry in Peru. In 1996, in an attempt to organize and manage a burgeoning microfinance sector, the Government of Peru (GoP) revised the banking laws to favor NGOs to become regulated MFIs, in essence requiring them to become private sector institutions, regulated and supervised by the SBS. The impetus for the new microfinance regulation, some believe, was that the government, wanting to support micro and small enterprises, felt that a well-managed microfinance sector could be a sustainable system to invest in these enterprises. The Peruvian regulatory framework for formal microfinance institutions sets specific rules regarding key financial ratios and provisions, granting well performing MFIs the legal status to take deposits. However to date, none of the Edpymes have been awarded this privilege due to a rather conservative approach of the SBS regarding this segment of the MFI market (Trivelli et.al., 2000; an interview with an SBS official, 2006).

Beside the formal institutions previously described, we find semiformal institutions and informal channels providing financial services, mostly loans. Semi-formal institutions, such as savings and credit cooperatives are under direct or delegated supervision of SBS, while NGOs are not financially regulated. Specialized NGOs supply very small loans in rural and urban areas. The Consortium of Private Organizations to Promote the Development of Small and Micro Enterprises (COPEME) plays an informal supervisory role to its financial NGO members by monitoring their financial and institutional outcomes as well as by providing training, resources and advice on sector developments. This helps to organize the semiformal sector while at the same time prepares NGO members wanting to become formal MFIs to meet SBS requirements. Informal financial channels include input suppliers, commercial traders, moneylenders, panderos and juntas (Peruvian rotating savings and credit associations - Roscas), and other family networks, and operate without any supervision.

Box 10.1 Confianza – Conquering Formal Microfinance Market to Persist Serving Rural Outreach

Confianza is an Edpyme headquartered in Huancaiy city located 300 kilometers from Lima, in the middle of the Andes highlands. Huancaiy is one of Peru’s major commercial and agricultural centres, marketing and shipping wheat, corn, potatoes and barley to the rest of the country. Confianza has six branch offices, four located nearby Andean small cities and two in poor neighborhoods of Lima.

History and Business Environment Preconditions

Confianza was created based upon agricultural lending experience and resources of Separ, a rural NGO providing education and credit services to the poor. In 1998, following the SBS incentives, Separ transformed its five-year-old agricultural lending program into the regulated Edpyme Confianza, complying with the stricter SBS regulation rules for formal MFI (Pearce and Reinsch, 2005; interview with the CEO of Confianza). By 1999, Confianza faced a severe delinquency crisis in which more than 50 percent of their loan portfolio was at risk for default. In order to address the crisis Confianza knew it had to make some difficult operational and managerial decisions.

Strategies and Financial Linkages

By 2000, keeping basic institutional goals of sustainability and outreach, Confianza implemented an overall organizational reengineering, including changes in its institutional management, funding policies for liabilities and equity, and lending technology and client approach. New funding strategies involved seeking all possible external financial sources, whether local or international ones. Confianza partners are formal and semiformal local financial institutions, international banks and organizations, acting as lenders and shareholders. Non-financial links involve advocators, observers and international leaders, all as institutional friends. Along the last six years, positive results include outstanding financial performance and increasing numbers of poor outreach, rural outreach, as shown in its annual reports.
Financial Linkages of Confianza

In this section, Confianza’s financial linkages are reviewed. In particular, its linkage types and actors are presented as well as the motivation for creating financial linkages and the impact they have had on sustainability and outreach, in particular rural outreach.

Linkage types and actors

Two broad types of linkages are proposed: facilitating linkages and direct linkages. A facilitation linkage involves an informal institution engaged by a formal one to act on its behalf, while a direct financial linkage involves a formal institution helping an informal institution to diversify its funding sources and/or balance its liquidity through bulk loans, lines of credit and savings instruments (Pagura and Kirsten, 2006). In this case, because Confianza developed multiple linkages, two more types are proposed here, related to their purpose and funding use: equity linkage and assistance linkage. Equity linkages involve a longer term engagement of the formal institution to the informal institution. In some cases, staff of the formal institution will serve on the board of the MFI it has invested in. An assistance linkage pertains to a formal institution, often non-financial, issuing a one-time grant or low to zero interest loan for specific technical assistance purposes.

Confianza has created linkages with several public and private sectors partners, both locally and internationally. Table 10.1 presents the multiple financial linkages in which Confianza has been engaged. Establishing a range of partnerships has been an integral part of its strategic growth and development plans. These linkages have helped to maintain and even increase its rural outreach over the years.

It is evident that Confianza relies heavily on financial linkages to fund its loan activities since it is unable to mobilize deposits. Facilitating linkages have involved low financial resources from formal MFI (e.g., Caja Municipal de Huancayo) and larger banks (e.g., Banco de Materiales) although these partnerships last shortly. Direct linkages with formal institutions have been the dominant type of linkage used by Confianza, including commercial banks (e.g., Banco Wiese, Banco Continental, Interbank), public apexes (e.g., Cofide and Agrobanco) and other institutions (Foncodes), international organizations (e.g., CAF) and private socially-motivated banks (e.g., Oikocredit, Hivos-Triodos). In addition, Confianza has created equity linkages with international investors (e.g., Interfin, Alterfin), as well as a small number of local investors, notably its parent NGO, SEPAR, and individuals. Technical assistance needs also induced Confianza to become partners with the Inter-American Development Bank (IADB).

Table 10.1 Confianza – Linkage Types and Main Partners, 2005.

<table>
<thead>
<tr>
<th>TYPE OF LINKAGES</th>
<th>PRIVATE SECTOR</th>
<th>PUBLIC SECTOR</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Local Institutions</td>
<td>International Institutions</td>
</tr>
<tr>
<td><strong>F: Facilitating</strong></td>
<td>- Caja Municipal Huancayo, - Edpyme Raíz</td>
<td>------</td>
</tr>
<tr>
<td><strong>D: Direct</strong></td>
<td>- Banco Wiese, - Banco Continental, - Interbank</td>
<td>- Corporacion Andina de Fomento CAF, - CreditoSUd, - Oikocredit, - Hivos-Triodos Fonds,</td>
</tr>
</tbody>
</table>
Notably, Confianza has been particularly successful in solidifying partnerships with international financial investors and partners. The following is a description of its most salient partnerships:

**TRIODOS**
- An international fund organization, self-defined as socially responsible bank to the microfinance sector, values the professional provision of financial services to microentrepreneurs as key for local economic development in developing countries.
- Through different funds, TRIODOS provides equity and debt, as well as its expertise in sustainable banking, to microfinance institutions.
- In 2000, when contacted, TRIODOS considered Confianza too small for consideration. Instead, Confianza asked for a 2-year period to show better portfolio results. After this span and good results, TRIODOS visited Confianza in the field and by 2003 issued credit lines.
- Since that time, TRIODOS has renewed its credit lines to Confianza given its continual positive financial evaluations as reported by Microrate.

**OIKOS**
- OIKOS is a Dutch privately owned cooperative society that works with (church and church-organization) private investors to fund socially responsible investments.
- Its main mechanism of operation is issuing loans for development, mostly to microfinance institutions, but also to cooperatives and small and medium enterprises, to support projects with cooperative perspective, women participation, environmental preservation and impact on community.
- Confianza contacted OIKOS in 2000 and obtained a $150,000 first loan for focusing on rural women of Peruvian highlands with poor financial access. Because of satisfactory outcomes, additional loans have been issued and paid in the following years, helping Confianza to fostering itself as regulated MFI.
- By 2004, OIKOS became a shareholder of Confianza, with an important equity participation.
NOVIB

- NOVIB is a Dutch-based organization that partners and works with Oxfam International, has as its main goal to eradicate world poverty and exclusion. Beside advocacy and awareness campaigns, NOVIB supports local development projects initiated by private organizations in developing countries.

- In 2000, Confianza motivated NOVIB with its institutional outcomes regarding rural credit, women involvement and work in the Peruvian central highlands. In 2001, after an in-field third-party consultancy work, NOVIB visited Confianza and issued a credit line for $400 millions.

- By 2002-2003 and because of good results, NOVIB also funded impact and institutional strengthening studies for Confianza.

- In 2004, on Confianza’s invitation, NOVIB became shareholder for a period of six years.

IADB – FOMIN

- As an investment fund of IADB, FOMIN is designed to channel donations and capital investment for private sector development, including development of micro and small micro-enterprises.

- The main FOMIN mechanism of operation is technical assistance by funding a group of projects for institutional development.

- In 2001, following an international competition, Confianza obtained a non-reimbursable technical aid grant for institutional strengthening, including activities of institutional technical assistance, training courses and software improvement.

- This FOMIN agreement contributed US$190,000 to the MFI while Confianza committed US$140,000 to the technical assistance project.

In conclusion, Confianza linkage strategy has been intense, generating a large, diversified set of formal and informal financial partner organizations. This has been a feature of this MFI general strategy for funding its financial activities. This overall strategy has allowed the MFI to overcome challenges of being legally allowed to mobilize deposits, which has impacted positively its ability to attend to its non-conventional clientele in rural areas.

Linkage motivations

As mentioned in Box 10.1, Confianza established a range of financial linkages and partnerships in effort to fund its ambitious, long-term growth plans. First, Confianza, in an effort to deal with a severe delinquency crisis in 1999 and to meet performance indicators set by the SBS, substantially re-organized itself, focusing on financial and operational sustainability. Faced with an inability to mobilize deposits on its own accord, Confianza soon realized that establishing sustained linkages with local and international partners was the only way that it could achieve its performance outcomes. By 2000, Confianza engaged itself in a very aggressive campaign within the country and abroad, to involve formal local and international institutions as partners to increase its funding resources. After five years we may conclude that these linkages have helped Confianza to become a competitive formal MFI, serving an increasing number of rural clientele.

Contracting mechanics

Confianza met many challenges in setting up appropriate contracts with its external partners, especially those abroad. To deal with the challenges head on, Confianza would often send its
General Manager, Elizabeth Minaya, to work out the contracting issues in person. Most all of Confianza’s international investors are socially oriented banks, pursuing social goals of sustainable banking, poverty eradication, microenterprise development. In other words, Confianza and its partners have a shared vision which helps to negotiate fair contract terms in the end. The contracting process is relatively straightforward and is based upon Confianza’s financial outcomes and outreach. First, Confianza applies for a first credit line with the objective of extending credit to the population that the investor is interested in targeting. The loan application review process ensues, which may include an in-field third party evaluation (as in the case of Novib). If accepted, Confianza works out the terms and conditions of the loan contract as well as the responsibilities of each party in the management of the loan. Typically, any risk from management is assumed by Confianza. The investor requires that an impact evaluation be conducted at the end of each debt cycle.

After full repayment, Confianza provides the investor its portfolio and impact evaluation results. This is often followed by an in-country visit by the international partner to Confianza headquarters in Huancayo. In some cases, international investors make equity investments in Confianza. This was the case for Triodos and Oikos banks when they became shareholder investors in Confianza in 2003 and 2004, respectively. Under these equity linkages, institutional risks and profits are shared, in relation to the participation owned. By 2005, foreign shareholders held around 60% of Confianza’s equity, with no one partner possessing a dominant share.

A potential weakness in the direct and equity linkages is the conditions set by international partners in terms of lending to a specific target group or to operate in a certain manner. These conditions sometimes do not allow Confianza to make its own choices freely. Confianza has addressed this challenge to some degree by accessing funds through local, commercial providers. However, there are drawbacks to this approach in that Peruvian commercial banks and apex organizations lend relatively small amounts for short periods of time. Thus, linkages with local providers have helped in funding their expansion issues, but have not had a significant impact on its rural outreach.

**Its role in capacity building**

It appears that financial linkages a range of partners have helped Confianza achieve its outreach and growth targets. Significant organizational transformations have occurred mostly since 2000, after most linkages with foreign institutions were set.

One notorious characteristic that also help was Confianza’s effort in distancing itself from its past NGO-heritage, in terms of management. While competing with other formal MFIs and meeting the SBS requirements, Confianza had to enforce operational and financial efficiency in its institutional perspective. Such changes also involved policies for human capital improvement, incorporating more professionals to the staff. Adjustments to the salary payments and incentives were also included.

Still, Confianza was committed to serving its rural clientele, as demonstrated by its target of maintaining at least 20% of its loan portfolio for rural clients. Confianza knew that in order to meet this this goal it would have to gain access to additional funds, locally and from abroad. Its outreach growth policy included the opening of new branches in rural and poor peri-urban areas of Lima. The financial linkages it established were instrumental in the organization achieving its targets.

Confianza has become an important MFI in the Peruvian market, including formal microfinance markets in rural and urban areas, and that is remarkable. Still some institutional problems are pending, and may be summarized in two: first, heavy dependence in one-person leadership for institutional, policies, decisions, contacts, vision, and so, with potential
problems of delegation, and second, its investment in physical resources is still modest, with significant low productivity of infrastructure, compared to other MFIs.

**Financial outcomes**

What are the main results of the overall strategy implemented by Confianza, more specifically after its engagement in multiple financial linkages over the last several years? Updated financial information provides interesting information on this question as presented in Table 10.2.

In terms of profitability, a low positive return on assets (ROA) and higher, but volatile return on equity (ROE) are observed, showing stable profitability of the MFI. During this period, Confianza has been financially self-sufficient, covering all of its financial costs. Still operational self-sufficiency problems have arisen after 2003, probably associated to new branches in farther areas, including rural areas. By 2005 Confianza overall operating expenses to outstanding portfolio ratio was (12.5%) decreasing but still above the market average. Loan officer productivity has increased on average, becoming the triple of the value for 1999. Growth of the loan activity and number of clientele, improvements in the credit technology and better positioning in the market may explain these results. In terms of the portfolio quality, its portfolio at risk ratio is moderate (almost 5 percent) and, at times, volatile. However, Confianza has decreased this ratio since 2004 and its portfolio write-offs are low and have been decreasing since 2003.

**Table 10.2: Confianza - key financial indicators, 1999-2005**

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<tr>
<td><strong>Sustainability/Profitability</strong></td>
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<tr>
<td>Adjusted Return on Assets (%)</td>
<td>-6.80%</td>
<td>5.10%</td>
<td>5.10%</td>
<td>3.50%</td>
<td>2.8%</td>
<td>0.95%</td>
<td>3.10%</td>
</tr>
<tr>
<td>Adjusted Return on Equity (%)</td>
<td>-13.40%</td>
<td>18.50%</td>
<td>22.50%</td>
<td>18.70%</td>
<td>15.4%</td>
<td>5.39%</td>
<td>18.06%</td>
</tr>
<tr>
<td>Operational Self-Sufficiency (%)</td>
<td>NA</td>
<td>1.55</td>
<td>1.73</td>
<td>1.75</td>
<td>1.84</td>
<td>0.85</td>
<td>0.89</td>
</tr>
<tr>
<td>Financial Self-Sufficiency (%)</td>
<td>NA</td>
<td>1.22</td>
<td>1.35</td>
<td>1.22</td>
<td>1.24</td>
<td>1.23</td>
<td>1.49</td>
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<td><strong>Operational efficiency</strong></td>
<td></td>
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<tr>
<td>Operating expenses as % of portfolio.</td>
<td>102.60%</td>
<td>19.70%</td>
<td>16.40%</td>
<td>15.90%</td>
<td>14.30%</td>
<td>13.76%</td>
<td>12.54%</td>
</tr>
<tr>
<td>Number of client per loan officer**</td>
<td>172</td>
<td>328</td>
<td>383</td>
<td>378</td>
<td>416</td>
<td>372</td>
<td>626</td>
</tr>
<tr>
<td>Number of borrowers per staff **</td>
<td>NA</td>
<td>94</td>
<td>134</td>
<td>147</td>
<td>174</td>
<td>248</td>
<td>233</td>
</tr>
<tr>
<td><strong>Portfolio quality</strong></td>
<td></td>
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<tr>
<td>Portfolio at Risk &gt; 30 days as % of portfolio. *</td>
<td>NA</td>
<td>0.20%</td>
<td>4.50%</td>
<td>4.20%</td>
<td>3.40%</td>
<td>4.67%</td>
<td>2.63%</td>
</tr>
<tr>
<td>Write-offs as % of average gross portfolio.</td>
<td>NA</td>
<td>1.10%</td>
<td>1.50%</td>
<td>0.90%</td>
<td>1.52%</td>
<td>1.29%</td>
<td>0.88%</td>
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<tr>
<td><strong>Outreach</strong></td>
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<tr>
<td>Number of loans outstanding</td>
<td>686</td>
<td>2,473</td>
<td>3,650</td>
<td>5,290</td>
<td>10,411</td>
<td>17,131</td>
<td>37,575</td>
</tr>
<tr>
<td>Outstanding gross portfolio ($)</td>
<td>391,000</td>
<td>1,495,083</td>
<td>2,699,332</td>
<td>4,407,154</td>
<td>7,967,678</td>
<td>13,468,588</td>
<td>21,533,771</td>
</tr>
<tr>
<td>Average outstanding loan size ($)</td>
<td>570</td>
<td>608</td>
<td>695</td>
<td>833</td>
<td>765</td>
<td>786</td>
<td>573</td>
</tr>
<tr>
<td>Average loan size as % of GDP/per capita.</td>
<td>28%</td>
<td>29%</td>
<td>34%</td>
<td>35%</td>
<td>37%</td>
<td>51.30%</td>
<td>38.33%</td>
</tr>
<tr>
<td><strong>Exchange Rate</strong></td>
<td></td>
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</table>
The performance indicators of Confianza’s agricultural portfolio are presented in Table 10.3. Between 2000 and 2005, both the number of agricultural clients and the number of outstanding loans have multiplied five times, while the overall agricultural portfolio practically tripled. There is one remarkable difference between the evolution of the overall and the agricultural portfolio. The portfolio at-risk is slightly decreasing for the overall portfolio, but increasing for agricultural portfolio, which explains a slightly higher default rate for agricultural loans as one would expect.

### Table 10.3: Confianza – Indicators for its agricultural portfolio

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<tbody>
<tr>
<td>Number of active clients.</td>
<td>682</td>
<td>631</td>
<td>671</td>
<td>2,148</td>
<td>3,063</td>
<td>3,102</td>
<td>3,501</td>
</tr>
<tr>
<td>Number of active loans .</td>
<td>791</td>
<td>1,085</td>
<td>1,300</td>
<td>2,195</td>
<td>3,011</td>
<td>2,952</td>
<td>3,253</td>
</tr>
<tr>
<td>Active portfolio (US$)</td>
<td>559,394</td>
<td>913,713</td>
<td>1,280,407</td>
<td>2,094,578</td>
<td>2,182,842</td>
<td>2,529,564</td>
<td>2,631,646</td>
</tr>
<tr>
<td>Average loan size (US$).</td>
<td>707</td>
<td>842</td>
<td>985</td>
<td>954</td>
<td>794</td>
<td>905</td>
<td>831</td>
</tr>
<tr>
<td>Portfolio at risk &gt; 30 days. *</td>
<td>NA</td>
<td>1.00%</td>
<td>3.30%</td>
<td>3.30%</td>
<td>10.28%</td>
<td>9.91%</td>
<td>9.53%</td>
</tr>
<tr>
<td>Agriculture as % of total portfolio.</td>
<td>37%</td>
<td>34%</td>
<td>29%</td>
<td>26%</td>
<td>31%</td>
<td>21%</td>
<td>14%</td>
</tr>
</tbody>
</table>

*Includes loan losses written off of Pampas Branch office as of 31 December 2004.

### Outreach

It is notorious that Confianza has continued serving its rural clientele while expanding into new, urban markets. In diversifying its loan portfolio, coupled with a sound re-organization of its operational and managerial systems, Confianza has protected itself against default crises of the past. Finding financial backers with a shared outreach vision and strategy has been a key factor to this success.

In terms of economic activity, almost 50 percent of the loans were for retail trade, 20 percent for agriculture and 9 percent for personal services; by gender, 46 percent were issued for women. Confianza strategies included a minimum share (20%) of agricultural loans in its total portfolio, and increasing penetration in other markets, included Lima. By 2004 average loan size was $720 (and $900 for agriculture), with more than 17,700 loans issued. By 2006, two Confianza branches operate in a poor urban zone in Lima city, with large presence of small retail ME.

The accelerated growth of Confianza activity might be largely influenced not only by its new organizational changes but also by its linkages. Most of Confianza linkages are with international partners, who are mainly financial institutions with social perspectives. These international partners pursue the expansion of the financial supply in rural areas, being peasants and women their main constituencies.

The average loan size to per-capita GDP has increased significantly, an indicator of the MFI market penetration, shows a slow but sure increase of Confianza ability to penetrate the microfinance market. Larger penetration among clients and wider outreach may have
pushed to these results. Also an important number of old clients continue working with Confianza, partially as consequence of an institutional fidelity program. Still a couple of potential outreach problems may emerge: first, the vulnerability of willingness to pay from agricultural clients, problem already experienced by Confianza in 1999 in some areas, although it appears that the internal policies that Confianza has set-up to minimize such systemic risks appear to be working. Another potential problem may have to due with the way in which the MFI deals with pressures to only court the most rumenerative clients, i.e., urban clients, in an effort to reduce risk and maintain sustainability. This may be less of a problem as the MFI is closely aligned with the vision of its parent-NGO, SEPAR, who is dedicated to serving rural clientele over the long-term.

**Unintended consequences**

As Confianza discovered, one does need to abandon one’s commitment to serving rural clientele if one develops the right institutional policies and procedures. By diversifying its loan portfolio to include urban as well as rural clientele and by obtaining long-term debt and equity finance through linkages, Confianza is in a better position to serve farmers and other non-farm rural folk on a sustained basis than it were able to do in 1999. This may not have been the case if the organization decided to maintain its NGO status, rather than becoming an EDPYME. For comparison purposes only, the case of ARARIWA, an NGO, focusing on financial services and rural development, is presented in Box 10.2. It may be the case that the additional level of formality that Confianza has attained by becoming a registered EDPYME in Peru has allowed it to access funds with a range of local and international partners. ARARIWA by contrast has had difficulty access these same funds. The local banks and apex organizations, nor most international investors, will not lend to NGOs that are not registered as EDPYMES. This makes organizations, like ARARIWA, heavily dependent on grants and funds from donors.

**Box 10.2 ARARIWA, an NGO for Rural Clientele**

**Brief Reference**

Located in the Peruvian highland Cuzco, region with more than one million people, 54 percent living in rural areas, with an illiteracy rate of 25 percent. Taking advantage of its historical heritage, Cuzco has developed a vibrant tourism industry. Agriculture and locally processed products are the main economic activities of its people. Petroleum and gold, exploited by foreign firms, generate fiscal resources for the regional government.

Arariwa has operated in the region since 1985, pursuing self-declared sustainable development of rural Cuzco by providing financial and non-financial services. Until 1994 in-kind donations from international donor agencies were its main resources. In 1999, under financial cooperation restrictions, Arariwa faced serious funding constraints. This external situation induced the NGO to make internal changes and review its organization and financial technology. The outcome of this review was the creation the Unit of Microfinance. ARARIWA created a credit fund to pull transfers and simplify management of its financial activities. Village banking is its predominant technology, with mid-term loans ($50 to $100), enforced savings and enforced non-financial services. Individual loans count for fifteen percent of portfolio, with larger amounts (around $500), flexible terms and lower interest rate. With only one office, Arariwa supplies financial and non-financial (promotion, training and technical assistance) services with thirty walking officials.

**Outreach Outcome**

By 2005 Arariwa operated in ten Cuzco provinces, nine in rural areas with more than 50
percent of its population being agricultural workers and community peasants. Most of its clients are peasants, small and micro-enterprises, engaged through the village banking technology and group lending mechanisms. Women have been an important target for Arariwa, mainly women of rural areas.

Main Financial Linkages and Contracting Mechanisms

Since its inception Arariwa has relied heavily on international transfers from donors engaged with similar social perspectives on rural development. When started in 1985 the NGO engaged with donors seeking in-kind credit support. After generalized default problems from peasants and new trends in the international cooperation, by mid 1990 Arariwa moved towards seeking financial support to extend its credit schemes, courting new international donors with similar outreach goals. Financial constraints and growth plans induced the organization to seek funding from local financial institutions. However, to date, the lack of market valued collateral and non-regulated status have preclude ARARIWA from obtaining loans from the financial sector.

By 2005, more than 70 percent of its debt finance comes from one source, Plan International, an international donor that increased financial and other links with Arariwa over the years. Contrary to diversification, Arariwa has opted to ‘put all its eggs in one basket’, relying on one financial partner. For the time being it appears to be working. Since 2003, ARARIWA has borrowed US$ 450,000 with zero interest rate for five years.

ARAWIRA has minor funding partners through its linkage with a local NGO network PROMUC (Promocion de la Mujer y la Comunidad that targets women economic participation), and another with ASDT and Inka (a Cuzco-based civil association), both counting for less than 10 percent of its total funds.

ARARIWA’s equity is largely composed of donation revenue. Donations were very large: 98 percent in 2002, 82 percent in 2005. Thus from the liability side, practically one partner counts: Plan International, making the organization highly vulnerable to shifts in the donor’s funding priorities and requirements. Although there appears to be a tradeoff as ARARIWA, it appears, has been able to reach poor rural clients.

Financial Outcomes

ARARIWA claims a default rate of 0.6 percent and a 100 percent coverage of its costs. Since it is not regulated by the SBS and other regulation authorities, nor a member of Copeme, the largest Peruvian NGO network, it is difficult to verify the reliability of these figures. It may be that the lack of officially recognized and accepted financial indicators has contributed to ARARIWA’s difficulty in accessing commercial debt and equity finance. Recognizing this fact, ARARIWA requested Planet Rating (an international microfinance rating agency) to evaluate its financial and operational efficiency. The results were good, showing satisfactory outcomes. Even still, this report has had little impact on its ability to create financial linkages with external partners.

Concluding Remarks

Serving non-conventional clientele, mainly rural clientele, requires a large amount of financial resources for lending activities. Because MFIs face funding constraints more than other financial institutions, strategies to increase such resources in a sustainable manner help to facilitate growth and outreach objectives. Based upon two Peruvian experiences, the main inferences of this study on financial linkages are as follows:
• Because of limited equity and internal funding, external financial resources are crucial for MFIs to supply their financial services in sustainable terms. This is more urgent when outreach includes non-conventional clientele of rural areas.

• Organizational type appears to be a significant factor in an MFI’s ability to access external funds and equity. Regulated MFIs have greater access with local and international investors.

• MFIs rely on linkages to fund their business growth and development objectives until they have received authorization from the banking authority to mobilize deposits. Trade-offs in time and costs may emerge when managing several linkages at the same time. Striking the right balance with a few good partners may be harder than it sounds.

• Financial linkages may have an impact on rural outreach if embedded into an overall institutional strategy of financial and operational sustainability which focuses on putting in the right mechanisms to deal with risks involved in lending for agriculture. Still these are not sufficient conditions because other determinants matter as well. Management issues may be critical to incorporate more rural clientele in sustainable terms. Also external funding providers may play a role in delimiting specific outreach, including rural outreach.

• Financial linkages facilitate increase financial activities of MFIs. Partnership with other MFIs and financial institutions in sustainable terms help the MFI to supply financial services in longer horizon while minimizing volatility risk of resources.

• Financial linkage conditions, amount and possible outreach may vary by type of partners engaged and the specific requirements and perspective of the MFIs. Other institutional conditions may also play a role in the success of the linkage.

• Financial linkages procure but do not guarantee obtaining large amounts of financial sources for lending and other services supplied to rural areas.

• The institutional frame matters for increasing financial funds to the MFI. Formal status reduces perception of risk to contract with MFI. Formal large financial institutions, local or international ones, prefer to do business with formal or regulated MFIs than those that are not. Formal status may appear as reducing asymmetric information problems from the MFI’s point of view.

• Management best practices are also crucial to minimize risks and transaction costs in serving microenterprise and rural clientele in a sustainable manner.

References


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SBS, [www.sbs.gob.pe](http://www.sbs.gob.pe)