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FINCA-COSTA RICA: LESSONS IN FINANCING RURAL MICROENTERPRISES

by

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Abstract

This paper describes the experience of FINCA-Costa Rica and derives lessons from it about providing financial services to low-income rural producers. The evolution of FINCA illustrates a progression from a paternalistic toward a modern vision of microfinance. The paper first discusses the difficulties of providing financial services to poor rural households and firms. It emphasizes information, incentive, and enforcement issues and unsuccessful attempts to overcome these problems through government intervention. It also analysis the costs of financial transactions in rural environments. FINCA has confronted these challenges with much success, through local organizations known as *bancomunales*. Flexibility and the search of self-sufficiency have been key features of the program.

FINCA-COSTA RICA: LESSIONS IN FINANCING RURAL MICROENTERPRISES[1]

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I. Introduction[1]

The experience of the Fundación Integral Campesina (FINCA) in Costa Rica has been a rich source of valuable lessons about how to overcome obstacles usually encountered in attempts to provide financial services to low- and medium-income rural producers, especially when they are scattered throughout remote areas. FINCA's clientele consist either of those producers who had had no access to formal or semiformal financial services before the organization's arrival in those areas or those who had been dislodged from the loan portfolios of the state-owned banks, as a consequence of the crisis of the regulated financial sector in the 1980s. Although the lessons from FINCA's experience are derived within a Costa Rican context, they are of general interest for all those concerned with the improvement of rural financial markets in developing countries.

Because FINCA has more beneficiaries than any other private development organization (NGO) in Costa Rica, this experiment has been important from this country's perspective. The program's national importance is underlined by the fact that FINCA has concentrated its activities in remote rural areas where the state-owned banks have not reached. There is an intense debate in Costa Rica concerning the best way to increase the rural population's access to a wider range of financial services, including opportunities to deposit as well as loans. Some of the participants in the debate challenge the assumption that only government-run development banks can reach low-income people in rural areas.

The experience of FINCA illustrates the possibility to find, when there is a creative vision, feasible alternatives to government intervention through the state-owned banks which have, in any case, gradually withdrawn from rural financial markets over the past decade (González-Vega,

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1. This is the introductory chapter in the book *FINANCING RURAL MICROENTERPRISES: FINCA-COSTA RICA* (Claudio González-Vega (ed.), San José: Ohio State University, Academia de Centroamérica, and the Inter-American Foundation, forthcoming, 1995), sponsored by the Project for the Research and Dissemination of the Experience of the Fundación Integral Campesina, FINCA, with support from the Inter-American Foundation and the Financial Services Project of The Ohio State University and Academia de Centroamérica.

2. The author is Professor of Agricultural Economics and of Economics at The Ohio State University. He is Director of the Rural Finance Program at Ohio State. The author is grateful for comments from Rodrigo A. Chaves, Ronulfo Jiménez, and Rodolfo E. Quirós and for the excellent translation by Mark Schreiner the Spanish version. The opinions expressed are those of the author and should not be attributed to the sponsoring organizations.

1993a). If appropriately designed, organizations such as FINCA have the potential to be attractive components in a system capable of satisfying diverse demands for financial services in the rural areas, at a reasonable cost.[2] This book offers important conclusions concerning the basic elements of such an appropriate design.

FINCA is especially interesting largely because of the organization's capacity, under the leadership of its executive director, María Marta Padilla, to learn from its own experiences and to adjust to changes in circumstances. Over time, FINCA has consistently drawn closer to the twin objectives of offering financial services to a large number of clients (outreach goal) while attaining financial viability and thus institutional self-sustainability.

The evolution of FINCA illustrates a progression from what was originally a traditional, paternalistic vision of the problems of finance and rural microenterprises toward a more modern perspective, through the gradual adoption of appropriate policies and practices to confront and overcome the complicated challenges of such a task. If the organization continues to improve in this direction, it has the potential to become a model for others to follow (Christen, Rhyne, and Vogel, 1994). The road left to be traveled still poses considerable danger, however, but the hope is that the lessons reported in this book will help keep the organization on the right track into the future.

The efforts of FINCA are also useful from an analytical point of view, because of the variety of contexts in which the local *bancomunales* have been developed and the variety of designs which have resulted from the members' efforts to create *bancomunales* to satisfy particular needs and preferences of their specific situation. In this sense, FINCA/Costa Rica has been an important laboratory of experiments in the financing of rural microenterprises.

This chapter examines the nature of the obstacles that often create stumbling blocks for organizations which attempt to provide financial services to a clientele of small rural producers. It also examines feasible ways to avoid tripping on these common hurdles. Crucial characteristics of FINCA's experiment will be evaluated using this conceptual framework. Finally, the chapter derives some general lessons which will be developed in greater detail in the rest of the book.

II. Access to Loans

Academics, experts in economic development, and political authorities have been deeply concerned for decades with the role that credit may play in the improvement of the welfare of low-income people. They have also inquired how this role is affected by the terms and conditions of the loans which households and businesses use in order to increase their command over the resources available to them for investment, production, and consumption.

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2. The services provided by organizations such as FINCA may complement interventions such as those represented by the Juntas Rurales of the Banco Nacional de Costa Rica (Jiménez and Quirós, 1994). This interesting experiment lost its best characteristics when politicians seized upon the Juntas as instruments, of planning and subsidy. Eventually, this led to their virtual demise. Gonzalez-Vega (1973) describes the original characteristics of the system.

Severe limitations on the availability of funds for lending to these marginal clientele stood out since the early 1950s when, after World War II, developing nations turned their attention to the promotion of rural development.

The diagnosis put forth at that time highlighted two presumed dimensions of the problem. First, it was noted that rural people had severely limited access to formal credit. An extremely small proportion of all rural producers had ever obtained even a single loan from a formal institution, and practically no one could count on reliable, permanent access to formal loans.[3] The second part of the diagnosis emphasized that informal credit, even though it was usually available, involved short terms and high rates of interest.

The assumption at that time was, on the one hand, that private commercial banks were excessively conservative and thus could never be expected to offer financial services to marginal clientele and, on the other hand, that the terms and conditions of informal loans were not only strangling borrowers, but also reflected in large part the monopolistic power of informal lenders.[4] When governments interpreted this situation as a case of market failure, where the market apparently could not generate the required volume of funds nor channel them to these sectors, the door was opened for massive government intervention in financial markets, in attempts to correct this problem.

Among these interventions were public development banks and special credit programs, usually managed by a ministry or a government agrarian reform or rural development agency. These institutions and programs easily became conduits for the disbursement of funds from international organizations and donors, government budgets, and central bank rediscount windows. These quasi-fiscal mechanisms provided lenders with the chance to distribute subsidized credit. This turned financial institutions into instruments for the government's policies, which destroyed any concern for their profitability or for the risk of their operations. The assumption was that the foreign sources of funds would always be willing and able to provide a steady stream of loanable resources.

The failure of targeted supervised credit and of subsidized loans has been well documented (González-Vega, 1993b). In spite of the large amounts of resources destined for agricultural

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3. Lumping together the categories of large and small producers, even by the mid-1970s only about 15 percent of the rural population in Latin America and Asia had ever taken a formal loan. For Africa, the figure was five percent (Donald). The poor had even worse access to institutional credit. The level of access to deposit services, which was not a main concern then, was also very limited.

4. In general, the exorbitant rates of interest which were used as examples of the exploitation of borrowers by informal lenders were extreme cases and for very short-term loans. According to Wai (1957), however, the average annual real interest rate in informal markets in many developing countries was usually between 24 and 36 percent. These figures did not differ from those observed for consumption loans in developed countries (Smith, 1964). The most important point is, however, that a large number of sources of informal credit (especially friends and relatives) do not charge interest or charge very low rates.

credit, access to loans remains extremely limited in almost all developing countries.[5] Not only is the proportion of rural producers with access to credit still very low, but institutional loan portfolios are extremely concentrated in a few clients as well. This implies that a small group of borrowers have received the greatest share of the loanable funds and have thus captured the benefits of the subsidy implicit in the below-market interest rates. The consequence has been a regressive subsidy, benefitting the rich disproportionately, and thus creating redistribution in reverse (González-Vega, 1984). In addition, these huge flows of funds have not always been converted into productive investment, and there is scant evidence that they have induced any increases in productivity.

These programs concentrated on disbursing loans and ignored deposit mobilization. They therefore did not fulfill their role as complete financial intermediaries. The attempts to target loans for specific uses and to supervise the use of borrowed funds increased transactions costs for all parties involved, further increasing the cost of credit. Subsidized loans often arrived late, in insufficient amounts, and encumbered by rigid, costly procedures. Subsidized loans were especially expensive for small borrowers, who could not dilute their high transactions costs over the size of their loan as well as the larger borrowers could.[6]

For the lender, the high transactions costs implied by attending to marginal clientele and the inadequate revenue generated by low rates of interest resulted in operational losses. These losses from operations combined with poor recovery of loans to gradually erode the financial viability of the specialized intermediaries which administered the credit programs. When it became obvious to borrowers who still had debts outstanding that the days of the lending institution were numbered, incentives to default grew large and thus levels of delinquency skyrocketed (González-Vega, 1990). These protectionist policies did not benefit depositors nor financial institutions. They did not even benefit the great majority of borrowers.

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5. At the aggregate level, financial repression resulted from administrative attempts to control the prices and amounts of financial transactions, to prescribe the use of borrowed resources, and to limit competition. Low and frequently negative real rates of return on deposits penalized savers. These policies of financial repression spawned explosive growth in non-regulated financial markets, currency substitution, and capital flight. They also led to a reduction in the real size of the regulated financial system and to disintermediation from institutions in the formal segment of the financial market. FINCA has met the demand for credit from those clients who were dropped from the portfolios of the state-owned banks in the early 1980s in Costa Rica (Quirós and Jiménez, in Chapter 3).

6. See González-Vega and González-Garita for a treatment of the high transactions costs incurred by borrowers from the Banco Nacional de Costa Rica. Money's fungibility guaranteed that the bank's attempts to control the use of borrowed funds did not have any significant effect on how borrowers allocated their loans.

III. The Costs of Credit

The failure of traditional credit programs can be attributed to an incomplete diagnosis, which blamed problems in rural financial markets entirely on market failure.[7] Limited access to loans and the high cost of credit do not, however, necessarily reflect market failure.[8] An alternative explanation is that financial services are expensive, because their production requires scarce human and material resources. In addition, a mistake in evaluating the creditworthiness of an applicant is socially costly, given both the waste of resources implied when purchasing power is allocated to someone who does not possess a sufficiently attractive investment opportunity and the damage wreaked by default on the financial viability of the lending institution. The heart of the problem is that it is neither easy nor cheap to provide financial services, even if there were no market imperfections. The combination of these two circumstances makes matters worse.

A financial transaction is possible only when lender and borrower can contact each other. For formal financial intermediaries, achieving this contact usually requires developing a significant physical infrastructure, for example, a branch network.[9] Such infrastructure usually implies high fixed costs. The intermediary can cover these fixed costs only when the density of the clientele and the size of the market permit spreading them over a sufficiently large portfolio. These fixed costs mean that dispersed populations and producers in remote areas will necessarily have more limited access to financial services. This fact is observed not only with banks, but also with such institutions as hospitals and colleges. Their high fixed costs prevent their being found everywhere.[10]

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7. Recent contributions to the literature have identified important cases of imperfections in financial markets (Besley). Despite of this progress on the theoretical front, such results remain a long way from being converted into robust recommendations for government intervention (González-Vega, 1993b). Among main obstacles are difficulties in quantifying relevant magnitudes and the failure of government intervention itself. Interventions in the past were particularly damaging, in that they not only were based on an incorrect diagnosis, but because they also used inappropriate instruments to try to correct the problems that did exist.

8. If not all households drink wine or own a car, this does not necessarily imply that these markets are imperfect. It simply means that wine and cars are expensive.

9. A well-developed public infrastructure is also indispensable. For example, borrowers need good roads to travel to a bank's offices at low cost. An efficient judicial system is necessary for the lender to enforce contracts. In the 1950s, financial services were particularly expensive in developing countries because of incomplete physical and institutional infrastructures (González-Vega, 1992). Such organizational infrastructure, indispensable in any well-functioning market, is critical for financial transactions.

10. In fact, the government's opportunity cost of developing a network of bank branches is precisely the value of the health and/or educational services that could otherwise have been developed.

Credit is costly mostly because the main inputs required to lend are not always available cheaply. Every credit transaction implies a transfer of purchasing power in the present in exchange for a promise of future repayment. The intermediary must manage its portfolio carefully because of the uncertainty involved in the honoring of this promise in the future. The tasks required involve:

(a) The gathering, accumulation, management, and interpretation of information, in order to establish the creditworthiness of the loan applicant and to determine the *ex ante* probability of default and the magnitude of the expected losses from default.
(b) The determination of the terms and conditions of the contract, by means of which the creditor attempts to constrain the actions of the borrower, in order to increase the probability of repayment.[11] Such terms and conditions also serve as a signalling device, to discourage riskier applicants.
(c) Monitoring the borrower after disbursement of the funds, to help ensure that changes in circumstances or diversions from the borrower's original plans do not hurt the probability of repayment.
(d) Enforcement of the contract, either through direct actions by the lender or through formal legal proceedings, to ensure complete or at least partial repayment as stipulated in the original contract.

Usually, the lender has limited information with which to try to establish the probability of repayment (Aguilera). There are, in addition, information asymmetries between the two parties to the contract. In general, the lender knows less than the borrower about the profitability and the risks of the borrower's projects. The lender has poorer information as well concerning the ability, level of effort, and moral character of the loan applicant. One of the most important tasks of any intermediary is to accumulate and improve its information base.

Information is an important input in the production of credit, but it can be very costly and it can never completely eliminate the uncertainty shrouding the prospects of future repayment.[12] For these reasons, the lender can never be completely sure that the borrower will fulfill his/her promise to repay. Unrecovered loans are very costly to the lender.

The risk of default depends on, among other things, events beyond the control of the two parties in the contract. It also depends, in part, on the borrower's actions. The lender wishes to

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11. This is an example of regulation via market mechanisms (Klein and Leffler). The lender designs the contract in such a way that the borrower has incentives (both positive and negative) to act in the interests of the lender. This is the case with collateral and other guarantees, required down payments, and prohibitions on the distribution of dividends. Other incentive mechanisms involve the borrower's reputation or social sanctions. See Chaves and González-Vega (1994).

12. No one can ever know with certainty future events, such as droughts, floods, revolutions, or fluctuations in prices, that can decrease the profitability of any given investment project. The lender can, however, use the available information to formulate distributions of the likelihood that such events may occur. This is costly.

create incentives so that failing to repay as specified in the contract is not an attractive option to the borrower. Mechanisms to discourage high-risk applicants include rigorous and credible sanctions in case of default, effective loan collection policies, and the requirement of viable (foreclosable) collateral. These mechanisms are costly to both borrowers and lenders.

In addition, money is fungible, so it is always possible that the borrower will divert the resources from the loan to activities that are riskier than those considered when the loan contract was drawn up. The effort expended by the lender in monitoring the borrower should balance the gains from monitoring with its costs. In cases of default, enforcing a loan contract can be particularly expensive, when the legal and institutional infrastructure does not provide the relevant services at low cost.

Several forms of segmentation are frequently observed in credit markets. One of the most common involves large borrowers with access to credit from formal institutions (banks) at relatively low cost and small borrowers (often the poor) with access only to (local) informal financial services. This empirical regularity results from the differential incidence of transactions costs, as much for the lenders as for the borrowers. These transactions costs depend on the distance between the contracting parties, the density of the clientele, and the nature of the technology used by the financial intermediary to produce financial services.

It is very expensive for a bank with urban headquarters to evaluate the creditworthiness and to monitor the activities of a rural (unknown) loan applicant who had no relationship with the bank before the loan application. The bank can reduce the distance between the applicant and itself only through heavy fixed costs in developing an infrastructure, but small markets cannot justify these costs.

Even if the potential borrower can offer collateral (and usually he cannot), the legal system is frequently ineffective at enforcing the contract. Traditional banking technology emphasizes the analysis of financial statements, feasibility studies, and other types of uniformly generated impersonal information that is not available from rural loan applicants. Without this information, however, the costs and risks for the bank look too high.

For the borrower, prohibitively high transactions costs result from visiting the bank's branch, collecting and presenting proper documents, and registering guarantees with government authorities. These costs usually do not depend on the size of the loan, and the small borrower can not spread them out over a large loan as well as a large borrower can.

Local intermediaries possess comparative advantages in cheaply collecting and interpreting personalized information, in monitoring borrowers, and in enforcing loan contracts. Monitoring and information costs are already sunk in places where everyone knows each other and is always up-to-date on everyone's activities. In addition, social sanctions are highly effective in small communities, because personal reputation has the utmost importance. Transactions costs are low because neither the borrower nor the lender require a formal contract.

Local, informal credit is expensive, however, because very limited opportunities to reduce risk through portfolio diversification mean that interest rates must be high. Any systemic shock (such as floods or price fluctuations) has a devastating effect on the community, and, as a result, on the portfolio of the local intermediary. The corresponding premium for risk has to be incorporated into the price of loans.

High risks not only make loans more expensive, but also limit the amounts that local agents are willing to gamble in lending activities. The supply of credit in a given locale is always

constrained by the limited wealth of the members of the community and by the narrow possibilities of intermediation implied when most of the population participates in similar activities.

The seasonality of agriculture makes matters worse. In periods when most people demand credit, there will be excess demand, and in those periods when most people demand deposits, there will be excess supply. This increases the opportunity cost of local wealth and contributes to aversion to risking a significant portion of local endowments in loans. The supply of funds from local agents will thus always be for small sizes, short terms, and restricted types of services. It will come from the moneylender's equity, not from deposit mobilization.

Potential excess demand can only be satisfied by external organizations which are less wealth-constrained and possess greater opportunities to diversify their portfolios. The fundamental dilemma is that these external organizations do not have the advantages of information and enforcement possessed by members of the local community. The supply of credit could be increased if efficient mechanisms would be found to unite these two ingredients, cheaper external funds with cheaper local credit procedures. This would occur when an external organization (a bank) could recruit local agents to manage its portfolio and provide the required services of information gathering, loan monitoring, and contract enforcement.

Connecting these two components presents new complications, however. The external organization needs information concerning which agents in the community can provide the required services efficiently. It must also ensure that the agents are honest, that they provide sufficient effort, and that they act in the interests of the owner of the funds. This is a typical principal/agent problem: how to constrain the behavior of the agent in order to achieve the goals of the principal. Its solution requires the design of a system with adequate controls and incentives structures. The most famous examples of success in the provision of financial services to small producers in rural areas have found effective ways to resolve these problems (Chaves and González-Vega, 1995).[13]

IV. FINCA/Costa Rica

The FINCA/Costa Rica program has been an interesting effort to confront these challenges and complications. Jiménez, Padilla, Quirós, and González-Vega describe in Chapter 2, as a central institution FINCA provides financial and technical support to local organizations known as *bancomunales*. FINCA can mobilize resources beyond those from simply capturing deposits in the local community, while the *bancomunales* can effectively manage the portfolio by gathering and using local information and by closely monitoring borrowers. The challenge for FINCA is to exercise enough control to recover loans and to increase the confidence of potential members of the *bancomunales*. Because this control implies some level of formalization of its operations, the challenge is to avoid unnecessary increases in transactions costs for the participants.

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13. This is the case for the various systems based on local units developed in Indonesia, where incentives are used to motivate the management and personnel in each unit's office, as well as in Banco Solidario (BancoSol) in Bolivia and Grameen Bank in Bangladesh, both of which use group-lending techniques to induce this cost-reducing, incentive-generating function.

FINCA serves clients in poor areas, where distances and low population densities make the provision of financial services prohibitively expensive for formal intermediaries. As Quirós and Jiménez report in Chapter 3, FINCA also serves producers who, in the past, had some limited access to formal (bank) credit but lost that access following the crisis in the financial system in the early 1980s. In both cases, these clients represent high costs for formal financial institutions. Local organizations such as the *bancomunales* possess some comparative advantages in this market segment. These advantages allow the community organizations to provide timely, cheaper, and more flexible services, even though they come coupled with interest rates high enough to cover all costs.

Aiming to provide credit services to poor rural people, the program at first suffered from many of the shortcomings of traditional interventions. Chapter 2 details some of the resulting problems. These weaknesses had negative effects on FINCA's efforts and included making loans and accepting repayments in kind rather than in cash, requiring obligatory savings, subsidizing interest rates, insisting on rigid repayment schedules, and failing to pay sufficient attention to the management of risk. The strength of FINCA has been its ability to learn and to adapt. With time, the executive director has increasingly emphasized financial viability in both the central office and in the local *bancomunales*. Policies and procedures have been amended with this goal in mind.

As related by Miller and González-Vega in Chapter 4, an increasing amount of effort has been focused on the mobilization of voluntary deposits, even though many problems in this area remain unsolved. FINCA abandoned credit in kind, raised interest rates to be positive in real terms, and paid more attention to the management of risk through concentrated effort on evaluating the potential borrower's capacity to repay. In Chapter 7, Chaves and Quirós analyze the resulting improvement in various indicators of the financial viability of FINCA. They also indicate several strategies to confront the remaining unsolved problems.

The advantages of *bancomunales* spring from their cost-effective generation of information, their opportunities to monitor borrowers, and their informal possibilities of enforcing loan contracts. FINCA attempts to regulate the operation of the *bancomunales* so that their behavior conforms with the interests of the headquarters, by gradually increasing the size of loans to them, by requiring a joint guarantee from the group that makes up the *bancomunal*, and by threatening to punish default with the withdrawal of service to the offending *bancomunal*. FINCA also uses mechanisms for internal control, through periodic visits to the *bancomunales* by promoters, at the same time that it invests resources in the development of the *bancomunales* and the training of their officials.

The groups' self-selection serves to identify those who are creditworthy, a task too expensive for FINCA, the external organization. The group also shares risks and generates implicit mutual insurance. In fact, Wenner (1990) used econometric methods to show that the default rate in the *bancomunales* was inversely related to their use of information in the selection of group members.

In spite of (expected) comparative advantages of group-lending in the areas of information and enforcement, the feasibility of the technique is still hotly debated, and the empirical experience does not give a conclusive answer (Huppi and Feder). In Chapter 6, Chaves proposes that the success of organizations such as the *bancomunales* depends on the policies and strategies that they adopt, which in turn reflect the incentives for those who control the organization. These

incentives result, in turn, from the structure of property rights and the governance rules that regulate relationships among the client-owners.

An analysis of the institutional design of the *bancomunales* helps identify some of their strengths and weaknesses, but it also leaves many questions unanswered.[14] Among problematic elements of the present design is the absence of an initial social capital which would represent risk capital provided by the members of the organization. The absence of this capital means that any losses experienced by a *bancomunal* puts its very existence in danger. Solving this problem may require an external agent with the power to assign the losses to the various members of the *bancomunal* and with the incentives and ability to aggressively pursue delinquent members (Holmstrom). FINCA, as the principal creditor for the *bancomunales*, is a natural candidate for this role. The costs, however, can be high.

The research of Wenner and that of Chaves and Quirós questions the ability of FINCA to cover all of its costs through revenue from its operations. With an increase in the scale of its activities and with rational efforts to reduce costs, however, it appears that FINCA is within reach of financial self-sustainability.

The provision of joint guarantees based on group solidarity and the fact that the admission of new members to a *bancomunal* rests with the current members has led to the formation of small, homogeneous memberships. Although this does allow the *bancomunal* to evaluate a loan applicant's creditworthiness at low cost, homogeneity increases the dangers implied by the possibility of systemic risk (covariant incomes and cash flows). This suggest the urgency of finding ways to diversify risk, a role which may be appropriate for an organization such as FINCA. A homogeneous membership also constrains possibilities for intermediation, and as such, the ample mobilization of local deposits. The headquarters of FINCA can also provide support for the *bancomunales* in this area.

In Chapter 6, Chaves argues that when joint liability guarantees are required, the borrowing group should as unsophisticated as possible. The requirement of group liability is no longer desirable if FINCA wishes to develop more complex organizations, however. In fact, this requirement has recently been eliminated by FINCA. One of the most critical challenges for the organization will be to choose the appropriate type of relationship between it and the *bancomunales*.

The lack of clearly pre-established rules for the distribution of *bancomunal* profits is an important weakness, particularly when the organizations create collective projects in addition to their financial activities. In Chapter 5, Chaves explores the agency costs associated with these collective projects and the dangers which they represent to the system. Again, the critical element is the design of the structure of property rights. Chaves analyzes different cases to demonstrate that the success of collective projects is associated with property rights structures that help to stimulate sufficient effort and which offer opportunities to monitor the effort of other participants. Clear rules for the distribution of profits and losses are an important element of an appropriate institutional design.

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14. In Chapter 5, Chaves argues that there does not exist a single optimal design applicable to each and every *bancomunal*, although optimal designs do share some common elements.

V. Lessons

The FINCA/Costa Rica program is one of several varied local mechanisms aimed at the provision of financial services to small farmers and microenterprises in rural areas.[15] Although the program belongs to the network of FINCA Internacional, the Costa Rican program has not blindly cloned the methods used in other countries. On the contrary, the paradigm has been adapted to the peculiarities of the national context and has strived with unusual effort to attain financial viability. Among other things, this has led to loans that are larger and are repaid over longer terms than in other countries, and to loan screening decisions based purely on the borrower's capacity to repay.

The lessons from this experience appear throughout the book, lessons that are as useful for development practitioners as they are interesting for academics. The rest of this chapter describes some of the general important lessons that have been derived from the experiment of FINCA/Costa Rica.

The experience of FINCA re-emphasizes that a private development organization (NGO) which wishes to reach a significant number of small producers with its services must start with the central goal of maintaining its own financial viability and that of the affiliated organizations, in this case the *bancomunales*. This is the only way such an organization can implement and plan its activities with a horizon that is both long and less uncertain. This vision of long-term permanence is indispensable, not only to permit the required learning and institutional development of the organization, but also to earn the respect, support, and confidence of its customers.

The policies that are adopted should reflect this concern for viability and should be oriented toward offering quality financial services at reasonable cost to the clients and at interest rates which cover the costs of intermediating funds for the organization. The original policies of loans in kind and subsidized credit did not match this concern for viability, and they would have led to the institution's demise if they had been not been discontinued. The executive director had the vision, however, to modify these incorrect policies and to march forward on gradual path toward self-sustainability.

An equally important step was the realization that the program was not altruistic, but rather a financial service which requires strict evaluation of the creditworthiness of any loan applicant and which is therefore oriented towards those small producers with low incomes, who nonetheless are capable of fulfilling their promises to repay. The paternalistic image developed in the first few years created problems with loan recovery and thus high costs for the organization. Even though these considerations have partially modified the profile of the typical borrower, FINCA/Costa Rica has not lost sight of its original goal of serving marginal clientele.

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15. Other similar programs, evaluated by Holt under the name *village banks*, include the activities of CARE in Guatemala, of Catholic Relief Services in Thailand, of Freedom from Hunger in Thailand, and of FINCA in El Salvador and Mexico, in addition to Costa Rica. The German firm Interdisziplinare Projekt Consult analyzed the experiences of FINCA in Honduras and El Salvador, before the design of a potential IDB program in Nicaragua.

The technology of combining resources from outside the community with local advantages in information, monitoring, and contract enforcement has apparently resulted in an effective system for serving clientele which otherwise would not have access to loans or which would have access only at significantly higher costs. The *bancomunales* have demonstrated the ability to use this information and to restrict entry to the group in order to reduce delinquency to satisfactorily low levels.

In the end, the success of the experiment requires not only correct policies and an efficient financial technology, but also and most importantly a stable organizational design. Unfortunately, the structure of property rights in the *bancomunales* has not been adequate to guarantee the desired results, and this structure needs serious revision. These organizational characteristics determine the incentives which influence the decisions made by those who control the *bancomunales*. Healthy financial policies and appropriate technologies will not be adopted nor put in place correctly if the incentive system does not make doing so in the interest of those who make the decisions. The importance of institutional design is evident at the level of the headquarters of FINCA itself, which also requires adequate incentives for its decision-makers at various levels.

FINCA-Costa Rica has not only been very successful as a private development organization, but it has also demonstrated a great capacity for leadership, learning, and adaptation. These virtues encourage an optimistic vision for the organization's future, as long as it continues its progress on its present path, until it transforms itself into a model program of financial services for rural microenterprises.

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