MicroEnterprise

Development Review January 2004, Vol. 6 No.2

Inter-American Development Bank

Special Edition: Lessons Learned from IDB Projects

In This Issue

Do Apex Models Make Sense for Microfinance?

Business Development Services: The IDB Experience

Inside:

Market Conditions in Four Countries 3

Pricing of Loans to IFIs and Microenterprises 4

Overview of Program Results 5

Promoting BDS Markets:

Institutional Mechanisms 8

Incentive Schemes 9

IDB Experiences 9

Program Results by Type of Intermediation Model 10

Do Apex Models Make Sense for Microfinance?

Marguerite Berger

The creation of national apex funds to finance microfinance is an often-heard demand from microfinance practioners. An IDB study of second-tier financing programs for microfinance sheds light on the promise and pitfalls of this approach.

The Microenterprise Global Credit Program (MG Program) of the Inter-American Development Bank (IDB) is an important chapter in the story of microfinance development in Latin America. The Program provides financing to commercial banks and other formal financial intermediaries to facilitate their entry into the microenterprise market. It is the largest wholesale (or apex)[1] microfinance program in Latin America.

(continued next page)

Business Development Services: The IDB Experience

Pablo Angelelli and Claudia Suaznábar

Today, the importance of business development services (BDS) for improving the productivity of smaller businesses is undisputed. The current challenge facing donor agencies is to design better mechanisms for creating and strengthening BDS markets in order to ensure that these markets function in a more sustainable and efficient way. This article summarizes a recent study by the Inter-American Development Bank (IDB), "Lessons Learned from BDS Programs for Small Enterprises in Latin America, 1995-2002." The study reviews the Bank's experience with BDS operations over the last eight years and

(continued on page 7)

The IDB has financed 17 MG Programs in 12 countries in Latin America. From 1990 to 2001, the IDB approved US$534 million in financing for these programs, and disbursed over US$356 million through second-tier institutions. These institutions in turn lent to 139 first-tier financial intermediaries with nearly half a million micro and small enterprise clients.

This article explores the factors that determined the outcome of the MG programs and their components, focusing particularly on Colombia, El Salvador, Paraguay, and Peru, which accounted for 8 of the 17 MG programs, and one-third of all IDB resources invested. These countries present an interesting range of experiences and span the full time period of the program, allowing for consideration of trends across countries and over time.

This review of the IDB's MG Programs shows that a wholesale, apex or second-tier mechanism can be used successfully to reach large numbers of microenterprises with financial services without damaging the performance of the participating retail lenders — when certain conditions are met. Although performance varied across the four MG countries highlighted here and evolved over time, as a whole, the MG programs can be credited with many positive outcomes.

2 Objectives and Characteristics of IDB's MG Programs

The objectives of the MG Programs are to increase access to credit for microenterprises, and improve the institutional development of financial institutions lending to microenterprises. Some of the programs include additional specific objectives, such as policy or environmental objectives, as well as access for nonregulated microcredit institutions to program resources. Thus, MG Programs support the development and strengthening of the microenterprise sector, not by simply channeling credit to the sector, but by developing sustainable services and institutions to connect microenterprises with formal financial markets.

The MG Programs utilize a two-tier structure to accelerate the expansion of microfinance services towards the microenterprise sector. A second-tier institution (in these cases, a public sector development bank or the central bank itself) channels financial resources through retail lenders — first-tier intermediary financial institutions (IFIs) — which in turn lend directly to microenterprises.[2]

Because the focus is on attracting commercial banks and other formal IFIs to the microenterprise market, and because the program seeks to provide targeted credit without sacrificing institutional sustainability and profitability, the limits on loan size are set considerably higher than the conventional definition of microcredit.[3] In order to discourage a clustering of loans toward the top limit, each program defines not only a maximum loan size but a maximum average loan size to which participating IFIs must adhere. The maximum average size is generally set at one-half the top limit or less, so that IFIs that make large loans are obliged to make many small loans as well. To encourage participating IFIs to invest in microfinance, some MG Programs include a technical cooperation component to defray part of the start-up cost of launching or developing microfinance operations, such as training staff and implementing systems to manage a high volume of small loans with minimal collateral.

Micro-Global Programs in Four Countries

Market Conditions. A range of conditions prevailed in the four countries analyzed in-depth for this study. When the MG Program began, El Salvador had just seen the creation of many new banks and finance companies in the wake of privatization. The relatively low level of initial capitalization required of regulated IFIs had allowed the nonprofit organization, AMPES, to create a for-profit finance company. In Paraguay, financial reforms that preceded the approval of the IDB's first MG Program strengthened regulation and supervision of financial intermediaries, putting pressure on the existing semi-formal lenders, known as *cajas de crédito*, to transform themselves into regulated finance companies. Competitive pressures led these maverick institutions to look for new markets beyond their traditional consumer finance base. Colombia presented a very difficult regulatory environment for microfinance throughout the duration of its three MG programs. Interest rate ceilings, high levels of initial capitalization for regulated IFIs, and the government's subsidized lending to microenterprises and MFIs created significant barriers to commercial microfinance. In Peru, the policy and regulatory environment was favorable. Financial regulations allowed the existing municipal savings banks (*cajas municipales*) to move into micro and small business lending, and the approval of the first MG loan coincided with the creation of the EDPYME, a new type of financial intermediary specialized in micro and small enterprise lending. Table 1 summarizes the prevailing market conditions in the four countries.

Performance Standards: The MG Programs defined a relatively standard set of financial performance indicators

[1] As the second-tier institution lending to participating retail lenders is not an apex per se, the terms wholesale and second-tier are used throughout this article.

[2] For IDB operations, a microenterprise is defined as one having 10 employees or less.

[3] In most MG programs, the maximum loan size is set between US$7,500 and US$15,000, and there is a maximum average loan size permitted of between US$2,500 and US$7,500.

Table 1. Summary of Market Conditions in Four Case Study Countries

	Colombia (1990-93)	El Salvador (1993)	Paraguay (1992)	Peru (1995)
Size of Microenterprise Sector	Med/Large	Med/Large	Large	Large
Regulatory Environment	Poor	Med/Good	Medium	Good
Donor/Government Subsidies	High	High	Low	Medium
Microfinance Industry Development	Medium	Low	Low/Med	Medium

that were used to screen IFIs applying for program funds, with the most important being portfolio at risk and profitability (generally ROE). IFIs were required to meet certain targets for these measures and maintain their performance at or above the target level to continue in the program. Specific eligibility thresholds for these indicators varied across the four countries studied, with El Salvador's MG program having the strictest criteria, and Peru and Colombia the loosest. At a minimum, the programs generally required positive real ROE, capital adequacy not less than 8 - 10 percent of risk-weighted assets, limits on the ratio of loans to deposits and on indebtedness to second-tier lenders, portfolio at risk greater than 30 days (PAR 30) not more than 10 percent, and PAR 90 not more than 3 percent.

Pricing of Funds. The pricing of funds is also an important determinant of institutions' willingness to participate, and of the incentives they have to maintain sound financial performance. Past targeted credit programs around the world erred by offering subsidized interest rates to participating IFIs, which saved them the trouble of mobilizing resources elsewhere – especially from deposits – and weakened them by leading them to become dependent on subsidized funds.

The MG Programs showed, however, that wholesale microfinance has significant transaction costs, such as those involved in meeting disbursement, reporting, oversight, and environmental requirements. The trick is to set the price of funds at a level that takes account of these transaction costs, but still does not displace savings mobilization or distort the market with subsidized funds.

With the exception of the first two Colombian loans, the pricing of MG resources to participating IFIs tended to be fairly uniform across countries.[4] It was based on a term deposit rate (generally 180 days) plus the imputed cost of reserve requirements that would have applied to such deposits. Participating IFIs were then permitted to set the interest rates they charged to their microenterprise customers, allowing the IFIs to cover their costs and profits. Drawing on data sources from different time periods, table 2 presents interest rate determination methods and notional levels of actual interest rates in the four countries studied.

Results of the MG Programs

Reaching Microenterprises. For the most part, the MG programs reached smaller businesses and more women borrowers than other credit operations in their countries. Loan sizes were generally less than half per capita income in each country (see table 3). Notable exceptions to these results are found in Argentina, Uruguay and the first Colombia program, where loan sizes were relatively large and many of the borrowers were existing clients of the participating financial institutions. The MG programs brought new borrowers into the formal financial system, and new lenders into microfinance. Up to 2002, 139 financial institutions had participated in the programs (not counting 32 NGOs that participated in Colombia), with 64 in the four case study countries (again excluding the Colombian NGOs).

Participating IFIs. The MG programs were most successful in developing specialized microfinance institutions or finance companies that had previously engaged in consumer lending, and less so in attracting existing commercial banks to downscale their operations to the micro level or in helping nonregulated NGO microfinance institutions to submit to regulatory exigencies. In only 3 of the 8 MG programs studied were there commercial banks among the top 3 participating IFIs. Peru was the exception to this rule: commercial banks there accounted for 50 percent of microcredits in the MG programs. There, the largest participating banks built on their experience in consumer finance to low-income wage workers to develop successful microfinance operations.

The Colombian case showed that some NGOs are also capable of providing sustainable microfinance services. But their inability to mobilize deposits and limited links to financial markets make it difficult for them to expand

[4] In the first two MG programs, Colombia financed IFIs at subsidized rates and imposed a ceiling for interest rates that could be charged to the final borrowers. In the third program, IFIs paid rates pegged to deposit rates, but the interest ceilings were maintained.

Table 2. Pricing of Loans to Participating IFIs and Microenterprises: Methods and Rates

MG Program (and period covered by the available data)	Cost to IFI (method)	Average Cost to IFI* (rate)	Interest rate charged to microenterprise (method)	Interest rate charged to microenterprise* (rate)	National average interest rate* for bank lending (rate)
Colombia I (average, 1987-1991)	Fixed	17%	Fixed	24%	41.9%
Colombia II (average, 1991-1993)	Time deposits plus 3%	30%	Fixed time deposits plus 3%	36% (average annual, all IFIs)	43.2%
Paraguay I (6/30/97)	180 d. CD adjusted for reserve requirement	25.6%	Determined by IFI	Annual rates of top 3 IFIs: 60%, 74%, 48%	28.1%
Colombia III (average, 1994 – 1997)	Time deposits plus 1%	29.6%	Determined by IFI	Avg. annual rates of top 3 IFIs (all NGOs): 53%, 33%, 17%	30.9%
El Salvador (average in 1997)	180 d. deposits adjusted for reserve requirement	12.5%	Determined by IFI	Average annual rate of the top IFI: 36%	16.1%
Peru I (3/31/98)	360 d. deposits adjusted for reserve requirement	7.7%	Determined by IFI	Annual rates for foreign currency lending, top 3 IFIFs: 34.5%, 59%, 20%	15.6% (in foreign currency)
Peru II (3/31/00)	Same as Peru I	Local: 20% Foreign: 8.3%	Determined by IFI	Annual rates for local currency lending, top 3 IFIs: 152%, 90%, 72%	28.1%
Paraguay II (31/12/01)	180 d. CD adjusted for reserve requirement	18%	Determined by IFI	66% (average annual rate, all IFIs)	28.3%

*Unless otherwise noted, interest rates cited are nominal annual effective rates in local currency; additional fees and commissions may have been charged and are not included in the rates cited.

Source for Pricing Methods and Rates: Project Completion Reports and Evaluation Reports of MG projects.

Source for interest rates in each country: IMF International Financial Statistics. For Colombia, rate is average loan rate of banking system. For El Salvador, rate is the rate charged by commercial banks on loans of one year or less. For Peru, rate is the average rate charged by commercial banks on loans of 360 days or less. For Paraguay, rate is the average commercial bank loan rate.

without continued access to wholesale funds from governments and international donors.

Due to the program's design, the impact on the performance of participating financial institutions was generally positive or neutral. The program had built-in safeguards to prevent overuse of MG resources at the expense of deposit mobilization: limits on borrowing from development institutions, appropriate interest rates and constant monitoring of performance indicators, including arrears, return on equity and return on assets.

Concentration of Resources. A large number of IFIs participated in the MG programs in the four countries studied (see Table 3), but program resources tended to be concentrated in a smaller number of IFIs. In El

Table 3. Overview of MG Program Results (1986–2001)*

Country and Program	Approval Date	Total Financing (000 US$)*	IDB Financing (000 US$)	Technical Cooperation (000 US$)**	Number Participating IFIs	Number Credits	Average Loan Size US$	1995 Income per capita
Colombia I	12/01/86	10,000	7,000		6	3,750	3,100	1,705
Uruguay	11/01/90	13,130	9,200	3,130	7	1,021	8,500	3,142
Colombia II	12/01/90	22,000	15,000	2,000	8	26,900	740	1,705
Ecuador	12/01/90	21,700	19,500	3,700	16	10,400	1,700	1,371
Argentina I	10/01/91	65,000	49,000	5,000	32	9,510	9,412	5,896
Chile	3/01/92	20,000	15,000	3,000	1	2,024	939	3,542
Guatemala	5/01/92	12,500	10,000	3,300	4	5,317	1,825	974
Costa Rica	11/01/92	17,600	13,000	3,300	5	6,531	1,114	1,003
Paraguay I	11/01/92	14,700	12,500	2,700	8	11,295	1,300	1,513
Colombia III	11/01/93	50,810	30,600	810	19	108,421***	581	1,705
Nicaragua	11/01/93	29,500	23,600	4,500	7	10,716	766	466
El Salvador	11/01/93	30,000	24,000	0	15	45,503	660	1,275
Peru I	09/01/95	39,650	27,750	3,950	16	31,038	1,017	2,084
Peru II	09/01/98	42,860	30,000	0	15	71,336	750	2,084
Paraguay II	01/01/99	25,000	22,200	3,000	14	44,584	688	1,513
Argentina	07/01/99	200,000	100,000	4,000	10	1,824	11,513	5,896
Bolivia	10/01/98	43,750	35,000	25,150	3	9,100	754	911
TOTAL		658,200	443,350	67,540	186	399,270	—	—
AVERAGE		38,718	26,074	4,221	11	23,486	1,176	—

* figures are for 1986-2001 only. Some programs are still in execution and a number of participating IFIs, microentrepreneurs and total loans have continued to grow in those cases.

**includes both IDB and counterpart funding

***includes reflows

Salvador, 91 percent of MG resources were used by the top 3 participating IFIs and 79 percent by one specialized microfinance institution, Financiera Calpiá. In Colombia, the top 3 participating institutions (one finance company and two NGOs) used 69 percent of MG III resources. The first MG in Peru exhibited the least concentration, with 54 percent of its resources used by the top 3 institutions (two commercial banks and one municipal savings bank). But in the second MG, 75 percent of resources were concentrated in the top three IFIs (two municipal savings banks and one commercial bank), although the top three institutions in MG II were not the same as in MG I. In Paraguay, 82 percent of resources were concentrated in the top three institutions in MG I, but that figure fell to 75 percent in MG II. It is encouraging that as the programs evolved, the composition of the lead institutions changed, and the share of resources going to the top institution tended to decline, at least in the Paraguay case. These findings tend to indicate that already existing MFIs are first out of the gate to capture MG resources, but others become interested over time.

Changes in Microfinance Climate. The programs contributed to a change in the perception of the microenterprise sector and have brought the sector closer to formal financial markets. They also helped to further the agenda for reform of regulations and supervisory norms to create an enabling environment for microfinance, especially in El Salvador and Peru.

What Makes Programs Successful?

Looking behind the results of the MG programs in four countries, it is evident that the most important factors in successful programs are:

- a large, concentrated microenterprise sector, where microenterprises account for a significant share of employment and businesses;
- an incipient microfinance industry, with at least one model microfinance institution and two other financial institutions with a commitment to undertake or expand microfinance operations;
- a facilitating regulatory environment, where it is possible to develop microfinance as regulated and supervised financial services, through specialized financial institutions and/or appropriate regulations and supervision practices for all IFIs;
- an effective executing agency with authority, independence from political pressures, transparency and resources to manage the program;
- efficient procedures for IFI selection, monitoring, disbursement and repayment of funds, in order to keep transaction costs low to participating IFIs;
- strict, transparent and relevant selection criteria and performance monitoring targets for participating IFIs that take account of the unique characteristics of microfinance;
- proper pricing of resources to participating IFIs: with interest rates charged to IFIs pegged to market-determined deposit rates — to avoid disincentives to savings mobilization but remain attractive to new entrants into the microfinance market;
- IFI flexibility in setting interest rates to borrowing microenterprises which allow IFIs to cover the high unit costs of microfinance and avoid disincentives to program participation; and
- high quality, targeted technical assistance to help participating IFIs adopt and adapt microfinance technology and improve their management and financial performance.

These factors fairly well represent the necessary conditions for success. However, in some cases, as happened in El Salvador and Paraguay, it may still be possible to develop a successful wholesale program when one or two conditions are not fully met, provided the program design works around limitations in these conditions. For example, lack of a model microfinance institution in Paraguay was balanced by the push and pull factors of change in the regulatory environment (which obliged key nonformal lenders to formalize) and outstanding technical assistance (which offered much needed support for the development of microfinance services). In El Salvador, the lack of technical assistance in the program was balanced by parallel technical assistance from other sources, although the assistance was concentrated in the program's lead institution.

Wholesale microfinance programs were most effective when used in conjunction with policy reforms to improve the environment for microfinance, or in countries where such reforms have already been undertaken, as seen in Peru and Paraguay. In Colombia, interest rate ceilings and government involvement in subsidized microfinance had the effect of keeping formal lenders from reaching down to smaller business borrowers and discouraging NGO microlenders from transforming themselves into regulated IFIs.

As for the question of whether the existence of a specialized microfinance institution under supervision of the banking authorities is a necessary condition for the success of microfinance wholesale programs, the answer is no. Of the four case study countries, only Peru had a specialized regulated microfinance institution, the EDPYME, and such MFIs together did not even represent 10 percent of the operations of the second MG program. In Paraguay, El Salvador and Colombia, specialized microfinance institutions were formed as finance companies under existing regulations and provided a full range of financial services. Colombia's regulated MFIs were not as successful in reaching down to microenterprises due to other legal and regulatory barriers discussed above. The Colombian case does show that one option for working around an unfavorable regulatory environment is to allow nonregulated NGO microlenders to participate in the wholesale program, although this reduces both incentives and pressure for better regulation and formalization of these lenders.

Client targets and loan size ceilings appear to be effective signaling devices for attracting IFIs that have a serious interest in microfinance, but they do not appear to create undue disincentives of participation in second-tier programs, as long as lenders have flexibility in setting interest rates to final borrowers. Use of loan size targets that established both maximum and maximum average loans was an innovation of the IDB's MG program, and it appears to have been effective in allowing lenders to make more profitable larger loans while including a significant volume of much smaller loans.

Issues Going Forward

The IDB's MG programs have shown that wholesale microfinance programs can be successful in expanding and deepening the reach of financial services for microenterprises, but such second-tier operations are not a panacea. Depending on the state of the microfinance industry in a particular country, other alternatives such as policy reforms to create incentives for the market to develop, technical assistance-only programs, and "picking winners" by investing in specific leading institutions can be superior approaches for advancing microfinance.

Even when wholesale microfinance programs are working well, it is important to consider the eventual exit strategy for this form of development assistance. Development agencies like to bet on winners, but wholesale programs that continue indefinitely could be subject to many of the same problems that plague state-owned retail financial institutions.

A two-tier financing structure can be a costly way to strengthen a few lead-

ing microfinance institutions and support their expansion. However, the leaders are not always easy to spot in advance, and even when they are, a two-tier model provides political cover by making financing potentially open to all IFIs in a country, even if a very small number utilize the resources on any significant scale. It also allows other IFIs observing from the sidelines to enter the market relatively quickly and test new products and clients they might have considered too risky or undesirable before.

Even where there are industry leaders, young microfinance institutions need financing over a sustained period in order to consolidate (e.g., Calpiá in El Salvador and the *cajas municipales* in Peru). It takes considerable time to build up the deposit side of their operations and to get access to institutional investments that depend more on local market conditions. Donor "capital" and technical assistance comes in at an early stage but often interest wanes after one or two project cycles. At this point loaned resources help give breathing room to consolidate specialized IFIs. Wholesale microfinance can be a good second generation MFI upgrading tool to beef up specialized IFIs, but care must be taken to avoid making these MFIs indefinitely dependant on development resources. This requires a long-term exit plan.

The timing should be defined by key parameters, such as: how broad and deep microfinance access should be for the industry to be considered mature enough to warrant "graduation" from such wholesale models; how narrow or broad the targeting of resources should be to signal participating IFIs to expand services to smaller and lower income borrowers without imposing excessive transaction and opportunity costs.

Although it was not the subject of this review, many development agencies now propose that impact measures be defined to assess the development effectiveness of such programs beyond their immediate impact on the financial sector, and achievement of impact goals would also influence the timing of exit.

Business Development Services: The IDB Experience

(continued from page 1)

draws out lessons that may be applicable to the design of future projects.[1]

Partly in response to the changing economic conditions of the last decades—increased globalization, the discovery of new technologies, and the transformation of traditional production models and consumer habits—there has been a surge in the demand for business development services. Nevertheless, information problems, lack of experience with BDS, difficulties in evaluating the benefits, and time and resource limitations have kept the demand for BDS low among micro, small, and medium sized enterprises (MSMEs). On the supply side, the lack of information about final clients and the high transaction costs involved in dealing with these enterprises are the main obstacles preventing most consulting and training firms from providing services to MSMEs.

Often it is assumed that public policy intervention is necessary to correct these market failures. Traditionally, BDS programs involved the direct provision of services by public providers or the permanent subsidization of services offered by other providers. In this way, donors and governments substituted for poorly developed BDS markets, possibly displacing commercial service providers. Furthermore, the available resources were frequently insufficient to cover the market, and programs ended when public funds ran out.

In the early 1990s, the IDB and other donor agencies adopted an alternative vision that proposed to meet the objectives of scope and sustainability set for these services by developing markets, rather than having donors and governments provide services directly. According to this vision, sound interventions require facilitating BDS transactions through intermediaries that use temporary incentives to stimulate businesses' demand for services and serve as catalysts for the development of private BDS providers. These interventions should be designed taking into account the particular institutional or market conditions of a region or sector, the types of services being promoted, and the type and size of the clients' businesses. This new demand-side orientation, including the creation of a sustainable institutional framework, grew in strength until it became a new paradigm for donor intervention.

The BDS portfolio study presented here identified 177 IDB operations from 1995 to 2002 that included MSME support and a BDS component. Of these, a sample of 85 operations with a market development focus was selected for further analysis. These operations represented a total investment of US$ 2.4 billion.[2] The intermediation models used by

[1] The study was conducted by SERVILAB and will be available soon at www.IDB.org/sds/msm. It is based on an extensive analysis of the Bank's official documents (project documents, progress reports) and on the results of a survey of program managers and IDB specialists in each country. It also includes five case studies of the most successful projects among the sample analyzed.

[2] The sample of projects includes approximately US$ 200 million investment in 137 grant projects and US$ 2.2 billion in 43 loan operations. The criteria for selecting the 85 projects were the following: (i) the project included at least one component for BDS market development; (ii) it had a level of execution higher than 20 percent; and (iii) the executing agencies shared the funding of the project.

the projects in the sample and the results obtained in terms of BDS market development are described below. Finally, the article includes an analysis of the challenges for improving the effectiveness of BDS market development programs.

Intermediation Models to Promote BDS Markets

Most BDS programs analyzed were horizontal,[3] providing services for businesses involved in any kind of economic activity (69 percent of BDS investment was in these kinds of interventions). The rest of the programs were sectoral, focusing on enterprises in specific economic sectors, such as agriculture, manufacturing, or trade. The study analyzed the intermediation methods of the projects sampled based on two parameters: the institutional mechanism selected and the incentive schemes used to develop the BDS market.

In Table 1 below, the institutional mechanisms used in the BDS programs are defined according to the public or private character of the intermediary agencies, making a distinction between private intermediaries that are remunerated by the market on a permanent basis and those remunerated by donors for a specific period of time. In Table 2, the three incentive schemes (the matching grant, the voucher, and the direct provision of services) used in these programs are explained in detail.

In the sample of IDB projects, the most common institutional intermediation mechanisms for developing BDS markets are those where a private agency is the market intermediary (Table 3). Public agencies are in second place and represent the largest share of investment. Structures that combine the participation of public and private agencies, though less frequent, account for 26 percent of investments.

The incentive scheme most used in the sample is the matching grant (Table 4). The high levels of incentives or subsidies used in the case of matching grants and vouchers, suggest that the BDS markets in which these interventions have taken place have been characterized by a very incipient BDS demand. Finally, less than half of the programs studied had anticipated or planned for the gradual reduction of incentives. This indicates that donor agency exit strategies have not been a significant factor in the design of most of the projects studied.

The New Focus on Developing BDS Markets: Results from IDB Projects

Market sustainability is the key variable for measuring the success of programs for developing BDS markets. If the program is a success, the MSME clients (the demand side) and the BDS

Table 1. Institutional Intermediation Mechanisms to Promote BDS Markets

Institutional Mechanism	Characteristics
Public Intermediary	A public agency directly administers the incentive system. Example: The Colciencias Program in Colombia, where the same institution administers and supervises a program to support innovation and the technological development of SMEs.
Private Intermediary	A private agency administers the incentive system and is remunerated for its services by the client. Example: The nonprofit organization Actuar Famiempresas in Medellín offers technical assistance services to manufacturing micro-enterprises, which pay a fee for the services.
Private Intermediary with Specific Time Period	A private agency administers the incentive system during a defined time period, after which the market is supposed to function on its own. The intermediation service that the agency provides is not remunerated by the market, but rather by a donor. Because of this, the agency must discontinue its market intermediary role when the funding runs out. One example is the voucher program administered by FEDISAL, a non-governmental organization that is remunerated for its intermediation services by donors only.
Public-Private Intermediary	A public agency contracts a private enterprise to administer the incentive system, while reserving the right to supervise the contract. Example: The current “three-tier” structure of the Bolivian public agency, SAT, in which SAT maintains the regulatory, financing, and monitoring functions of the program (third tier), and delegates the registry of BDS providers (first tier) and administration of training vouchers to private agencies, which constitute a second tier.

Source: *“Lessons Learned in Business Development Services (BDS) Programs for Small Enterprises in Latin America, 1995-2002.”*

[3] BDS programs can either be horizontal (services are directed to businesses of any economic sector or activity) or sectoral (services are directed to businesses in the same sector).

providers (the supply side) should continue to undertake transactions with their own resources after donor funding has ended. On the supply side, as the market evolves, the variety of services supplied should expand and include both national and international providers. The quality and relevance of the services offered should improve as well.

On the demand side, what matters is the number of enterprises that purchase BDS with program support, the percentage of clients who request the services again, the degree of client satisfaction, and the clients' predisposition to continue contracting these services, as well as any change in sales and average employment in the client enterprises themselves. The first four indicators give an idea of the scope of the program, while the last two show the impact the services have had on business growth.

The overall results of the study indicate in general terms that some important advances have been achieved in terms of sustainability of business development services. On the supply side, almost four out of every five projects brought about an increase in providers, and 90 percent of the projects saw an improvement in the quality of services offered. On the demand side, the repetition index for clients using the services during the life of the projects is around 1.5. Sixty percent of the clients were satisfied with the services they received, and a little more than half of them appear to be willing to continue to contract non-subsidized services in the future. Nevertheless, as Table 5 shows, a more detailed analysis reveals differences in the results obtained by program type and institutional mechanism. The following section explains these differences.

An analysis of the results obtained by type of institutional mechanism indicates that private agencies perform better than public agencies. As Table 5 shows, this superior performance shows up primarily in the improvement in quality, relevance and client satisfaction with the services as well as, to a lesser degree, the sustainability of the market and changes in client sales. This could reflect advantages private agencies may have in management, familiarity with the market, flexibility and capacity for learning. When private agencies act in coordination with one or more public agencies, however, their performance levels are lower.

The results by type of incentive show that voucher programs are more effective at stimulating supply: they appear to produce a greater increase in the number of BDS providers and have a stronger impact on price reduction for

Table 2. Incentive Schemes to Promote BDS Markets

Incentive Methods	Incentive to Stimulate...	Characteristics
Matching-grant	Demand	• The enterprise or individual client assumes a percentage of the cost of the service. • Whether on its own or with the help of an intermediary, the client looks for a provider in the market. The client then presents a proposal for the intermediary to approve and finance. • Usually covers a broad range of more sophisticated and specialized services. • High administrative costs generally result from tailor-made services for each business and the case-by-case study of proposals.
Voucher	Demand	• Vouchers are a form of payment with a fixed value, usually lower than the value of the matching-grants. • Vouchers are given without cost to clients who choose among providers previously accredited by the intermediary. • Services are typically standardized modules of basic training for micro-enterprises. • Provides the possibility of impacting a larger target market with costs below those of a matching grant method.
Direct Service Provision	Supply	• Incentives are subsidies that go directly to a service provider so that it can offer services at a below-market rate. • The method is typically used in markets that are not very developed on the supply side. • Decreasing subsidies with time limits are typical in this method.

Source: Own elaboration.

Table 3. Institutional Intermediation Mechanisms Employed in the Sample of IDB Projects

Category	Projects		Total Forseen Cost	
	Number	% Total	Value (thousands of US$)	% Total
Public Intermediary	10	11.8%	1,639.067	66.2%
Private Intermediary	65	76.5%	175.879	7.1%
Public-Private Intermediary	8	9.4%	654.879	26.4%
Private Intermediary with Specific Time Period	2	2,.%	6.433	0.3%
Total	85	100%	2,476.258	100%

Source: *"Lessons Learned in BDS Programs for Small Enterprises in Latin America, 1995-2002"*.

Table 4. Types and Percentages of Incentives in the Sample of IDB Projects

Type of Incentive	Number of Projects	Fixed Incentive[1]		Decreasing Incentive	
		Number of Projects	Percentage of Incentive	Number of Projects	Percentage of Incentive in the First Year
Matching Grant	34	24	51.0	10	62.8
Voucher	6	3	44.2	3	53.3
Direct Service Provision	23	6	25.0	17	64.6

NOTES: [1] Fixed incentives remain constant throughout the life of the project, while decreasing incentives are reduced as BDS markets develop, and are often used as an exit strategy of the donor agency.

Source: Ibid.

BDS services. The impact on MSME clients in terms of sales and employment, however, is still weak, and there appear to be difficulties in market sustainability associated with this type of incentive. The matching grant and direct service provision schemes, on the other hand, show more improvement in sales and employment for MSME clients and higher sustainability of the service. One explanation for this would be that the target population for voucher programs is typically made up of lower income groups who have a greater sensitivity to the price of the services and less knowledge of the benefits of the services than the target populations in the other two incentive modes.

Finally, an analysis by type of program shows that those that promote horizontal services have a greater impact on BDS supply, but they show worse results in terms of service quality and client satisfaction. At the same time, the sectoral programs have a higher positive impact on the sustainability of the services and on the sales and employment of the client businesses. The study shows that sectoral projects have also yielded better results than horizontal projects in terms of coverage of the target population and compliance with project execution deadlines.

Conclusions and Remaining Challenges

The following summarizes the conclusions of the study on programs promoting the development of BDS markets:

- **There is a trade-off between the outreach of a project and its effectiveness.** This can be seen in the case of programs that promote sectoral rather than horizontal services. The former, directed to more homogeneous and limited target markets score higher in all of the indicators for BDS market development except for an increase in the number of providers. The primary explanation for this is that in projects with a narrower scope, the executing agencies tend to know more about the market in which they are intervening, both on the supply and demand sides. How to resolve this trade-off is a key challenge for future projects.
- **Private agencies have a comparative advantage over public agencies**

Table 5. Program Results by Type of Intermediation Model

	Institutional Mechanism			Type of Incentive			Program Type	
	Private Agency	Public Agency	Public Agency that Subcontracts	Matching grant	Voucher	Direct Service Provision	Horizontal	Sectoral
Increase in Providers (%)	40	65	30	48	85	40	62	53
Quality and Relevance of Business Services[1]	2.9	2.5	2.8	2.9	3.0	2.9	2.8	3.0
Change in Price[1]	2.1	1	2	2.1	2.3	2.0	2.1	2.0
Degree of Client Satisfaction[2]	4.4	4	4	4.1	4.3	4.5	4.3	4.4
Predisposition to Continue to Contract Services with Own Resources[2]	3.5	2.7	4	3.6	2.5	3.5	3.4	3.5
Change in Sales[2]	3.8	3.3	3.5	3.7	2.7	3.7	3.5	3.8
Change in Employment[2]	3.5	3.7	3.3	3.4	3.0	3.5	3.3	3.6

SOURCE: Ibid.

[1] The survey assigns values from 1= unfavorable to 3= favorable;

[2] Survey assigns values of 1 to 5 with 1 = not at all satisfied and 5 = very satisfied.

as facilitators of BDS market development. Private agency advantages are seen in all of the indicators, except the increase in the number of BDS providers. These advantages, such as ex-ante understanding of the market, closeness to the client, flexibility, and capacity for institutional learning, become decisive factors for a BDS program. Mechanisms to promote cooperation between public and private agencies should be improved in order to capitalize on this advantage. The division of responsibilities between the two should be clarified by providing sufficient incentives for the participation of the private sector in the execution of services and narrowing the public sector role to focus more on policy and financing functions.

- **The sustainability of BDS markets in the medium term continues to be a challenge.** This is shown by the low predisposition of clients to pay for services, especially when a public agency is the executor, or when low initial levels of economic development and limited awareness of the benefits of BDS characterize the target market. In these cases, where there are high initial subsidies, clients are less willing to accept later price increases for the services they are receiving, and BDS providers are less willing to have their subsidies reduced or eliminated for fear of jeopardizing their contracts. This has blocked the gradual reduction of subsidies. For future projects, exit strategies should be designed with longer timelines to allow for some kind of structural transformation in markets. However, above all, it is key to find ways to reduce the cost of these services. This might be accomplished, for example, by adjusting new products to the needs of smaller businesses in order to lower the final cost to the client.

Microfinance Rating and Assessment Fund

The Rating Fund provides partial financing of rating and assessment services for microfinance institutions by specialized raters/assessors. For more information about the eligibility criteria of the Fund and how to apply, please consult the Fund's web site: http://www.mfirating.com.

VII Inter-American Forum on Microenterprise

Cartagena de Indias, Colombia

September 8, 9 & 10, 2004

SAVE THE DATE!

In Future Issues...

Social Entrepreneurship: A New Vision for the Development of Poor Communities

Best Practices in Village Banking

Inter-American Development Bank

Inter-American Development Bank
Micro, Small and Medium Enterprise Division, B-0800
1300 New York Avenue N.W.
Washington, DC 20577, USA
Fax: (202) 623-2307
e-mail: sds/msm@iadb.org

Microenterprise Development Review

Editors: Marguerite Berger and Claudia Suaznábar
Other contributors to this issue: Pablo Angelelli, María Fé de los Heros, and Kathy Ogle

The views and opinions expressed in the articles are those of the authors and do not necessarily reflect the position of the Inter-American Development Bank.

The Micro, Small and Medium Enterprise Division manages the IDB's microenterprise projects with the private sector and provides training, disseminates best practices, and develops policies and strategies to guide Bank country operations and promote the growth of the microenterprise sector in Latin America and the Caribbean.

Contributions to the *Microenterprise Development Review* are welcome. Please send articles and comments to the Technical Notes Coordinator of the Micro, Small and Medium Enterprise Division. This and other publications of the Micro, Small and Medium Enterprise Division are available in Spanish and English at the Home Page of the Inter-American Development Bank: http://www.iadb.org/sds/msm.