Introducing Rural Finance into an Urban Microfinance Institution: The Example of Banco Procredit, El Salvador

by Juan Buchenau and Richard L. Meyer

This paper was chosen through an open call for research in rural finance, whereby the selected individuals were invited to Rome, Italy, to share their results during the conference and to discuss key issues in shaping the rural finance research agenda as well as ways of strengthening the ties between research, policy and practice.
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ABSTRACT

Banco ProCredit El Salvador (formerly Financiera Calpiá) was started as an NGO in 1988 to serve urban micro entrepreneurs. Over time it grew and developed a well-performing portfolio, but continued to limit its operations to urban areas. In 1992, it began to modify its individual lending technology to fit the demands of rural clients, and started experimental lending in favorable areas with lower risk farmers. A pilot project was initiated by granting loans to small farmers producing vegetables. The target areas were selected based on three criteria: accessibility, proximity to a Bank’s branch office, and a secure water supply to minimize the risks of crop failure due to drought. The success of this pilot led to an expansion in lending to riskier farmers. Over time, the rural portfolio has grown and the organization has successfully met two major external shocks, an earthquake and a collapse in maize prices.

This paper provides insights into the process undergone by Banco ProCredit El Salvador to introduce this innovation and into the lessons learned about the obstacles and facilitators to this process. It presents in detail:

1. a brief review of the history and evolution of the organization
2. a description of how this technology was introduced and integrated into the institution
3. a description of the individual lending technology and adaptations made to serve rural areas, of the lending procedures as well as of the characteristics sought in rural loan officers and the training provided to them
4. data reporting on the evolution and performance of the institution and its rural and total loan portfolio
5. a discussion of how Banco ProCredit El Salvador has weathered major external shocks

6. comparative data on the work load and performance of rural and urban loan officers

7. characteristics of the rural clients

The paper will end with a summary of the lessons learned from the successful introduction of rural lending and its potential limitations¹

¹ This is an expanded and updated version of an earlier paper entitled “Individual Lending in Rural Finance: The IPC Model” presented at the seminar on Current Issues in Microfinance, August 12-14, 2003, Misty Hills, Johannesburg, South Africa. We want to take the opportunity to thank ProCredit El Salvador and especially Mr. Gabriel Schor, Mr. Stefan Queck, Mr. Miguel Rodríguez and Mr. Juan Carlos Arenas for sharing with us valuable information about the institution’s performance.
INTRODUCTION

Given the widespread failure of many private and public financial institutions in rural areas, expectations on microfinance institutions entering this market are high. In spite of this, only a few urban microfinance institutions have been successful in their endeavor to serve rural households. Expansion into rural areas poses very special challenges, especially for lending, which is constrained by dispersion, seasonality and specific risks related to agriculture.

Financial institutions must create a lending technology\(^2\) they will employ in attempting to serve their targeted clients. The design of such lending technologies becomes complex when financial institutions undertake to serve low-income people in developing countries. Being self employed, having only limited (and mostly untitled) assets and being mostly unable to document their income, the poor do not meet the requirements of banks. One of the major innovations of the microfinance industry during the past two decades has been the exploration of different types of lending technologies for use in serving those denied access to loans from formal financial institutions. Solidarity group and village bank programs use groups to transfer some of the normal loan screening and contract enforcement functions to clients. These borrowing groups serve as collateral substitutes. Other financial institutions, however, use an individual lending technology to serve poor clients in developing countries. Research conducted in Bolivia showed that some microfinance institutions

\(^2\) As defined by Schmidt and Zeitinger (1996), the term lending technology covers “the entire range of activities carried out by a loan-granting institution which have to do with selecting borrowers, determining the types of loans to be granted, the loan amounts and terms to maturity, and ways in which loans will be secured, as well as the monitoring and recovery of loans.”
(MFIs) using individual technologies had roughly the same mix of poverty levels among their clients as did the solidarity group lenders (Navajas, et al., 2000).

This paper summarizes the experience of Banco ProCredit (formerly Calpia) in El Salvador in designing an individual lending technology for its operations in rural areas, a lending technology which was later adapted by other ProCredit institutions in Latin America, Eastern Europe and Uganda. The paper will describe the technology and report some of the important results obtained to conclude with some remarks about its comparative advantages.

BACKGROUND

IPC (Internationale Projekt Consult) is a German consulting firm, organized in 1981, that has used an individual lending technology in its many projects to develop financial institutions in developing countries. In 1998, it created Internationale Micro Investitionen (IMI) to make investments in financial institutions serving micro and small enterprises and other mostly low-income families. IMI was later converted to ProCredit Holding. Currently ProCredit Holding has investments in 19 banks in the same number of countries where IPC is providing technical assistance. They are concentrated in Eastern Europe, Latin America and Africa. As of December, 31st, 2006, these institutions had almost 750,000 loans outstanding with a total value of around $ 2.7 billion.³

Banco ProCredit El Salvador in El Salvador is a financial institution with which IPC first began working in the early 1990s. ProCredit El Salvador began as the

³ The statistical data summarizing the 19 institutions can be found on the web site www.procredit-holding.com.
nongovernmental organization (NGO) Calpia in 1988 to provide emergency relief after an earthquake devastated the country. It began operating a rotating credit fund to support small and micro businesses in urban areas with a strong commitment to treat this support as loans to be repaid rather than grants. The German aid agency GTZ provided funding in 1991 for IPC to begin transforming it into a regulated finance company (*financiera*). In 1993 it began to expand to the national level and to increase its outreach into rural areas, which required developing agricultural loan products (Churchill, 1999). In 1995, it was formally incorporated into the financial system as a *financiera* and in 1999 was recognized by the InterAmerician Development Bank as the best microfinance organization in Latin America. In June 2004, Financiera Calpia was transformed into a full-fledged bank changing its name into Banco ProCredit El Salvador.

The expansion into agriculture required the institution to adapt its successful urban lending methodology to the specific characteristics of small farms. A pilot project was initiated in October 1993 by granting loans to small farmers producing vegetables. The target areas were selected based on three criteria: accessibility, proximity to a branch office, and a secure water supply to minimize the risks of crop failure due to drought. The pilot phase ended in early 1995 after almost complete repayment of the first group of loans granted. It demonstrated that it was possible to establish a commercial relationship with small farmers that were quite distinct from the paternalistic approach followed by the state-owned agricultural development bank (Buchenau, 1997). A decision was made to expand the credit program to other irrigated areas and later on to rain-fed areas.
DESIGNING THE LENDING TECHNOLOGY

The key elements of the ProCredit El Salvador lending technology are summarized in this section. More detailed information about the rationale for the technology can be found in Buchenau (1997 and 2003). Moreover, a highly detailed analysis of the technology, including an in-depth description of the characteristics and role of the loan officers, can be found in Navajas and Gonzalez-Vega (2000).

Conditions of Rural Clients

The challenges of lending to rural people, and especially farmers, in developing countries are well known (Zeller, 2003). The differences between rural and urban areas have important implications for rural finance such as:

• higher transaction costs for both financial institutions and clients due to more dispersed clients, small sized transactions, and poorer communications and transportation infrastructure,

• higher systemic risks due to climatic and disease problems, more volatile cash flows associated with seasonality and variations in farm prices, and more complex, heterogeneous environments for conducting business and financial transactions,

• lower risk-bearing ability of borrowers and higher vulnerability of poor rural households, which increases their demand for consumption smoothing rather than investment loans, and
• a lower commitment of development agencies, a weaker implementation of
development policies, and often an urban policy bias.

At the same time, agriculture and financing agriculture are highly politicized and
frequently subject to government intervention in the event of high food prices, natural
disasters, and balance of payments constraints.

El Salvador poses some specific challenges. It is a densely populated (250
inhabitants per square kilometer) poor country ranking 101 out of 177 countries in the
2006 Human Development Index. In 2004, about 44 percent of the rural population
was considered poor relative to 29 percent to the urban population. Civil war
damaged the rural infrastructure in the 1980’s and the country has been suffering
under random and organized crime which affects all aspects of life since the end of
the war. Given these difficult living conditions and the relative openness of the United
States to immigrants from El Salvador in the 1980’s and 1990’s, an estimated 1 – 2
million Salvadorians have migrated to that country, sending almost $3 billion per
year home in the form of family remittances. Contributing to about 17% of the
country’s GDP, remittances have become an important source of income in many
parts of the country and of many of the rural and urban customers served by Banco
ProCredit.

Weak institutions, outdated legal systems and inadequate agrarian reform
legislation increased transaction costs and slowed the expansion of banking into rural

4 See http://www.gpn.org/data/elsalvador/el-salvador-data.pdf
5 See http://www.iadb.org/mif/remittances/index.cfm
areas. The dominant state-owned financial institutions have been plagued by political intrusion and lack of sustainability (Navajas and Gonzalez-Vega, 2000). Most farms are small with few assets and many farmers rent much of their land. They produce mainly cereals, vegetables and cattle for milk and meat, and many earn income from non-agricultural activities (Buchenau, 1997). Agricultural GDP growth was very uneven during the 1990s and the first years of this century. It averaged 8 percent per year from 2000 to 2005 but was a negative 7% in 2002. Only 7.9 percent of rural households reported access to formal loans in 1997. Just over 12 percent reported access to loans from semiformal sources including cooperatives and NGOs (Navajas and Gonzalez-Vega, 2000).

Requirements of the Lending Technology

The credit technology designed for rural areas and small farmers had to simultaneously meet ProCredit El Salvador’s requirements of controlling costs and risks while providing clients with services appropriate to their demand and characteristics. Therefore, the products and procedures designed for use in rural areas had to meet the following conditions:

- Credit services need to serve the multiple demands of producers with diversified and changing economic activities rather than being geared exclusively to agricultural production. Borrowers will likely demand loans to help maintain consumption levels and to maintain and, in some cases, expand or diversify income-generating activities.

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6 Access was defined as receiving a loan during the year or having an outstanding loan that was received in the 1994-97 period.
• The credit analysis of the potential borrowers needs to treat the farm-household as a unit with multiple objectives and activities. Loan amounts, disbursement procedures, and repayment schedules need to be highly flexible and custom designed to fit the repayment capacity and cash flow of the borrowers so investments can be made, family consumption requirements met, and repayments made on a timely basis. Conservative estimates of expected production, prices and cash flows are required to make certain that loans are not made that exceed the borrower’s repayment capacity.

• Shorter-term loans have to be treated as part of long-term relationships with clients and credit decisions taken quickly and funds disbursed without delay. Transaction costs for the borrowers need to be kept low especially during peak labor demand periods in the planting and harvesting seasons.

• Farmers have little education and usually no written financial statements so the credit analysis needs to be done with information collected and analyzed by credit officers who personally know the prospective borrowers and have good knowledge about their operations. Borrowers must clearly understand the obligations they are undertaking. The terms and conditions must be clear, reasonable and transparent.

• The borrowers must be able to pay the level of interest rates required to cover the high administrative costs and risks involved in making small, flexible loans so the financial viability of the institution is preserved.
• Attention must be paid to verifying the information provided by clients and creating incentives for repayment. The previous repayment performance and reputation of potential clients need to be evaluated through credit references provided by firms with which clients have business relations, relatives, friends neighbors, and, if available, by other credit institutions through credit bureaus.

• Loan officers need to establish good rapport with clients, visit their homes and businesses to assess management capacity, and maintain close contact with them, especially at harvest time, to remind them of their repayment obligations. They must respond quickly to visit clients if payments are not made promptly when due.

• The collateral accepted for loans needs to be appropriate for small farmers and include items with high subjective or use value to the borrower even if they have limited market value. Assets such as household appliances, animals, farm equipment, and land documents (titles, receipts for payment of taxes, etc.) meet these criteria.

• Production and price conditions for major commodities need to be monitored during the growing season so that potential repayment problems can be anticipated. Special measures, such as extending the loan repayment period, need to be applied on a case-by-case for borrowers who are expected to experience repayment difficulties.

**The household cash flow as an important element of the rural lending technology**

One of the distinctive features of rural lending is that loan appraisals and design have to consider the type, sources and timing of household cash-flow with
their associated seasonality and risks\textsuperscript{7}. To cope with this, ProCredit El Salvador uses cash-flow projections, which include all significant sources and uses of revenue for each household to determine the loan amounts to be granted as well as the optimal repayment schedule.

The example in the following box demonstrates the procedure for doing this.

Box 1:
The example assumes a household that generates income from a variety of sources: milk produced by one cow, operation of a small village store, and production of corn and coffee:

- The cow produces a total of 9 liters/day, of which 3 are consumed by the family. The remaining 6 liters are sold at the local market at a price of $0.20/liter. The cow is set dry in November in preparation for calving.
- Corn is sown in August. The family sets aside 700 pounds of this grain for farm and household consumption and sells the rest. Coffee is harvested and paid for in December.
- The cash income from the village store fluctuates with agricultural income. In the difficult months before the harvest, the store generates less cash, as sales are reduced and some of the sales are made on credit. In the months of the corn and coffee harvest, sales increase while customers’ loans are repaid. Goods sold in the store are purchased monthly at a local market for cash.

\textsuperscript{7} See Meyer and Alicbusan (1984) for an illustrative example of a rural household’s cash flow management in Thailand.
The use of cash for family consumption fluctuates also with agricultural income. It hovers around $50.00 per month.
According to the described seasonality of household incomes and expenses, the family expects a cash deficit in July, August, October and November, which it will overcome using the cash at hand ($60.00) and an external source of funding. The family will generate a cash surplus in September, and especially in December and January, which will allow repaying debts and buying some larger-cost items.

The projected cash flow is used to visualize and discuss different loan options. It provides insights into the effects of different loan sizes and also of different loan structures (e.g. the use of “bullet payments”, of partial disbursements, of grace periods on principal and/or interest payments, etc.). The following table shows a projected cash flow based on the example shown and exemplifies one loan option which could suit the expected cash flow, assuming an interest rate of 2% per month on the outstanding balance.
Table 2: Example of a tailored rural loan

<table>
<thead>
<tr>
<th></th>
<th>Cash at hand</th>
<th>Month's result</th>
<th>Cash flow before the loan</th>
<th>Loan disbursed</th>
<th>Loan repayments</th>
<th>Cash flow with loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jul</td>
<td>$24</td>
<td>$(24)</td>
<td>$36</td>
<td>$100</td>
<td>($2)</td>
<td>$136</td>
</tr>
<tr>
<td>Aug</td>
<td>$(94)</td>
<td>$(58)</td>
<td>($58)</td>
<td>($2)</td>
<td>$40</td>
<td></td>
</tr>
<tr>
<td>Sep</td>
<td>$6</td>
<td>$6</td>
<td>($52)</td>
<td>($2)</td>
<td>($2)</td>
<td>$44</td>
</tr>
<tr>
<td>Oct</td>
<td>$11</td>
<td>$11</td>
<td>($41)</td>
<td>($2)</td>
<td>$53</td>
<td></td>
</tr>
<tr>
<td>Nov</td>
<td>$(25)</td>
<td>$(25)</td>
<td>($66)</td>
<td>($2)</td>
<td>($2)</td>
<td>$26</td>
</tr>
<tr>
<td>Dec</td>
<td>$(155)</td>
<td>$(155)</td>
<td>$89</td>
<td>($52)</td>
<td>$129</td>
<td></td>
</tr>
<tr>
<td>Jan</td>
<td>$243</td>
<td>$243</td>
<td>$332</td>
<td>($51)</td>
<td>$321</td>
<td></td>
</tr>
</tbody>
</table>

 Procedures for Lending and Loan Recovery\(^8\)

This section describes the actions and procedures followed by rural loan officers to make and recover loans. They are similar to those used in urban lending, but adapted to the circumstances of rural areas.

- Marketing, screening, and signaling. The process of interacting with potential new clients involves loan officers explaining the opportunity to borrow from ProCredit El Salvador, signaling that these loans must be repaid unlike others they might have received elsewhere, and screening those that have the ability and willingness to repay. The first contact often comes through a charla (orientation talk) given to an individual or group in a branch office or some central meeting place. In the charla, they are informed about the services offered, the lack of red tape, and the flexibility to meet individual demands. They also learn their responsibilities as borrowers. To qualify,

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\(^8\) This section largely summaries the detailed description presented in Navajas and Gonzalez-Vega (2000) which includes the results of interviews with all 15 rural loan officers and a sample of 8 out of 53 urban loan officers.
they must 1) have a productive opportunity, 2) have alternative means of payment (collateral and/or other income), 3) have no delinquent loan elsewhere, and 4) be trustworthy. The loan officer signals that ProCredit El Salvador is serious about repayment by explaining that in case of default all agreed penalties will be used including the seizure of collateral. The process is expected to encourage self-selection, as noncreditworthy persons will be discouraged from making applications. It apparently achieves its objective as about 30 percent of the potential clients decide to not pursue a loan after hearing the charla.

- Interview, application and verification. A loan officer interviews potential clients who remain interested after hearing the charla. This is the first step in a comprehensive evaluation process. The interviewer asks about the farm household, its economic activities and sources of income for repayment, purpose for the loan, potential sources of collateral, and credit history. If the initial responses about production, yields, income and loan size and purpose seem reasonable, the loan officer will complete an application and start the process of client and loan assessment. The applicant is asked to identify documents that will support the application and identify at least two references who are not relatives. The loan officer will contact the personal and commercial references and review available credit bureau reports to verify if the information supplied is reasonably accurate and if the client has a good repayment history with other lenders. This is followed by an on-site visit to the client’s home, place of business, and local community. The visit to the home provides an opportunity to view intra-household relationships, the condition of potential collateral, and documentation such as receipts for purchases and sales and titles for property. The loan officer inspects the land, standing crops, equipment,
buildings and livestock to evaluate the farmer’s potential and management skills and to discuss how the loan will be used. Interviews are conducted in the community to evaluate the client’s work habits, management capacity, character, and history of meeting obligations. Information and recommendations provided by current borrowers are expected to be particularly valuable, as they understand the seriousness of the decision to borrow.

- Credit report. The loan officers evaluate all the information obtained and use office computers to prepare appraisal reports for the credit committee. It contains several items. The cash flow projection is prepared including the expected quantity and timing of household revenues from all sources and expenses. The farmer’s predicted crop productivity is calculated as a weighted average of 1) the highest yield ever reported, 2) the most recent yield, and 3) the worst yield recorded. Prices are imputed as the minimum expected market price. A balance sheet is also prepared that lists household and farm assets, their value and outstanding liabilities. The collateral is identified and valued, and if co-signers are involved, a report on their capacity to pay is included. Usually the collateral value is expected to be 100-150% of the loan amount. The cash flow projection is then used, as shown above, to design the proposed loan, including its amount, term, and repayment schedule, if the loan officer recommends that a loan be granted.

- Credit committee. The function of the credit committee is to approve, modify or reject loan applications. It consists of the loan officer, branch credit coordinator, or

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9 The formula assigns the highest yield and the most recent yield scores of 1 each, and the worst yield a score of 2. The sum is then divided by 4.
10 Collateral values of less than 100% are accepted for small loans of $200-300.
branch manager. For larger loans, the ProCredit El Salvador credit manager and even the general manager may be included. For loans up to approximately $15,000, the process is fast and the decision may be made the day the report is submitted by the loan officer. Normally the process from application to disbursement takes only three to five days in the case of new customers. Larger loans take longer as they must be reviewed in the head office when the committee members are available to meet. Repeat customers are usually served in one to two days, depending on their repayment history and the time passed since the last assessment. Customers with a history of more than 18 months in excellent standing are awarded VIP status that entitles them to get access to “automatic loans” which are handled similar to a line of credit against which they can draw almost instantly after answering a short questionnaire. Some 75 to 90 percent of the applications are approved, about 5 percent are rejected, and the balance are made with modifications. The approval rate is higher for more experienced loan officers and for repeat clients.

- Loan terms and conditions. Agricultural loans are made for an average of ten months. Livestock loans are made for 15 to 18 months. Some interest and partial principal payments are requested from clients who are projected to have the necessary cash flow. Otherwise a single bullet payment is required at loan maturity covering both interest and principal. Annual nominal interest rates are between 12% and 27% charged on the unpaid loan principal. In the case of the smaller loans a 4% percent origination fee is charged for bullet payment loans while 1%-2% is charged for loans with multiple payments.
• Disbursement, monitoring and contract enforcement. Loans are disbursed in the branch office usually as one lump sum and all payments must be paid there to minimize the fraud that could occur if loan officers handled these in the field. Loan officers occasionally visit clients as time permits to monitor how their activities are progressing, but not to specifically monitor if loan funds are being used as agreed. Loan officers make visits for preventive monitoring if some negative shock such as a quake or a drought occurs, or if it is reported that the client is ill or has family problems, or if a large loan is made and scheduled to be repaid in a single (balloon) payment at maturity. Loan officers are advised the day after a payment is missed and a visit is made to the borrower in the form of corrective monitoring if a loan payment is overdue after about five days. The officer evaluates the reasons why the payment was missed and warns the client of the consequences of developing a poor credit history and of the eventual seizure of collateral. A penalty charge is assessed for late payments. A late payment agreement may be arranged if the delay is expected to be temporary. Otherwise, if late payment persists for 30 days, collateral is seized. This is possible because the borrower voluntarily signs a document stating that the asset is offered in payment of the loan obligation. At least half of the clients pay their obligations within 15-20 days in order to redeem the seized collateral. The loan officer is responsible for selling the asset if not redeemed. In the case of animals, arrangements are made for traders or neighboring farmers to buy them. If the sale does not cover the loan balance plus accrued interest, the difference may be eventually written off. Loans which are not recovered in spite of credible efforts from loan officers are at some point eliminated from the loan officer’s portfolio.
Loan Officers

Much of ProCredit El Salvador’s success or failure in rural lending is determined by the quality and performance of its loan officers. They are responsible for the evaluation of loan applications, for the design of the loans made, and for loan recovery. They must establish good and trusting relationships with clients so they obtain reliable information for sound loan appraisal. Therefore, it is essential that they are able to communicate in the language of farmers and understand their values and desires. They must be committed to serving this group of clients, and have professional training and/or experience in agriculture to efficiently evaluate the applicants’ management capacity, future yields, and production risks.

ProCredit El Salvador prefers to hire young people around 30 years of age who are about to receive degrees from local universities, with little or no banking experience. It looks for professionals with established ties to the communities where its branches are located. The typical rural loan officer lives in the vicinity of the branch and has a university degree in agricultural sciences with some exposure to accounting, computer sciences, and financial analysis. In the early years of rural lending, many had some experience working for the agricultural development bank, for rural NGOs, or in agriculture (Navajas and Gonzalez-Vega, 2000). Most are male because of the need to travel in the countryside on motorcycles.

Newly hired staff members are given two weeks of training in the characteristics of rural enterprises, techniques to evaluate production conditions in the field, methods for evaluating loan applications and designing loans for clients, and the
importance of building strong relations with clients. After completing training, they spend two to three months working as shadow loan officers making loans under the close supervision of an experienced loan officer. During this period, they develop keen insights about how to evaluate evidence of good management practices used by clients. Special emphasis is given to improving the quality of their credit appraisals and measures used to achieve high loan recovery.

Incentive systems for loan officers based on a standardized formula were widely used until recently by IPC to stimulate high productivity of loan officers and good quality loan portfolios\(^{11}\). While this system generated a high performance, it also generated ongoing discussions and tensions within the institutions and made it less attractive for excellent loan officers, who could contribute in a role as coordinators or branch managers to the institution’s progress to move up the scale, as they were already earning a relatively high salary and it led to a “burn out syndrome” if loan officers were working beyond their capacity. The system was replaced in Banco ProCredit El Salvador and elsewhere by a three component approach, which includes: a) improvements in benefits and insurance for all employees (thus promoting internal cohesion within the institutions); b) rewards of up to two months of salary for exemplary conduct of individuals within the banks below the management levels (which is given for both exemplary performance and/or exemplary social conduct); and c) profit sharing for a selected group of the middle

\(^{11}\) The formula that determined the incentives paid consisted of stock indicators (portfolio size and number of borrowers), flow indicators (number of new borrowers), and portfolio quality (arrears) (Navajas and Gonzalez-Vega, 2000). Highly efficient loan officers could earn bonuses up to 100% of their base salary.
management after participating in a three year training course (rewarding the long-term commitment of promising employees)."12

Although farmers have several sources of income to help even out labor requirements and household cash flows, inevitably there is seasonality in the workload of rural loan officers linked to the seasonal production of major crops. Loan officers must efficiently organize their work in light of this seasonality. The peak period for loan analysis and disbursement is March to June, which is the main planting season. This is followed by the relatively slow period during the growing season from July to October. The peak loan recovery period occurs from December to February. During peak agricultural periods, loan officers work evenings and weekends to keep up with the demands of their jobs. During slack periods, they make nonagricultural rural loans, contact new potential clients, conduct studies of potential new markets, catch up on paperwork and schedule their vacations.

THE PERFORMANCE OF PROCREDIT EL SALVADOR

This section reports some key performance data for ProCredit El Salvador and for the loan technology. Two performance criteria are explored. One concerns the financial sustainability of ProCredit El Salvador as an institution. The second concerns its outreach measured by both the number of clients served, and their poverty levels. Outreach and sustainability are two of the three criteria presented in the critical triangle of microfinance for the evaluation of microfinance institutions.

12 See: Zeiterger (2005)
(Zeller and Meyer, 2002). The third criterion is impact, which falls outside the scope of this paper.

**Overall performance**

ProCredit El Salvador has performed well as a regulated MFI. It has been operating profitable since early in the 1990s. The data in table 3 show this as well as a steady increase in lending, the mobilization of deposits and the distribution of remittances. Average loan size has crept upwards as existing clients have graduated to larger loans, but there is no evidence of mission creep in the sense that first-time borrowers are less poor now than were the first-time borrowers a few years ago. With almost 140,000 deposit customers and 80,000 loan clients, it is one of the larger MFIs in Latin America.
Table 3. Key Indicators of ProCredit El Salvador Performance, End of Year, 2000-2006.

<table>
<thead>
<tr>
<th></th>
<th>Number of staff</th>
<th>Number of outstanding Loans</th>
<th>Total Loan Portfolio in EUR '000</th>
<th>Average loan amount of outstanding loans in EUR</th>
<th>Deposits in EUR '000</th>
<th>Number of money transfers in preceding month</th>
<th>Return on average assets (ROAA*)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec 00</td>
<td>233</td>
<td>37,621</td>
<td>31,259</td>
<td>831</td>
<td>15,623</td>
<td>0</td>
<td>2.9%</td>
</tr>
<tr>
<td>Dec 01</td>
<td>245</td>
<td>38,019</td>
<td>35,628</td>
<td>937</td>
<td>16,791</td>
<td>0</td>
<td>1.3%</td>
</tr>
<tr>
<td>Dec 02</td>
<td>301</td>
<td>44,771</td>
<td>42,717</td>
<td>954</td>
<td>21,723</td>
<td>6,306</td>
<td>1.9%</td>
</tr>
<tr>
<td>Dec 03</td>
<td>374</td>
<td>54,298</td>
<td>52,707</td>
<td>971</td>
<td>28,131</td>
<td>10,354</td>
<td>2.9%</td>
</tr>
<tr>
<td>Dec 04</td>
<td>479</td>
<td>63,368</td>
<td>66,223</td>
<td>1,045</td>
<td>45,108</td>
<td>12,414</td>
<td>0.8%</td>
</tr>
<tr>
<td>Dec 05</td>
<td>539</td>
<td>66,617</td>
<td>86,809</td>
<td>1,303</td>
<td>55,018</td>
<td>13,816</td>
<td>1.6%</td>
</tr>
<tr>
<td>Dec 06</td>
<td>691</td>
<td>77,504</td>
<td>99,228</td>
<td>1,280</td>
<td>71,345</td>
<td>18,705</td>
<td>1.3%</td>
</tr>
</tbody>
</table>

*) Note: annualised, after impact of currency revaluation
Exchange rate as of December 31\textsuperscript{st}, 2006: $ 1.32 for each Euro

**Evolution of the lending portfolio**

The rural lending program was introduced for the first time in 1993. Rural loans are now made in 23 of the 27 branches. The total share of rural loans grew from around 23\% in 1995 to 2000 to about 36\% in 2002, when ProCredit’s management decided to promote their rural lending operations more aggressively. The portfolio has continued to grow, although at a slightly slower pace than the urban portfolio. As of December 2006, rural loans contributed 32 percent of the total number of loans in ProCredit El Salvador’s portfolio (Table 4).
Table 4. Number of Loans Outstanding, End of Year, 1995-2006

<table>
<thead>
<tr>
<th>Year</th>
<th>Rural</th>
<th>Urban</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995 (6 months)</td>
<td>2,799</td>
<td>9,261</td>
<td>12,060</td>
</tr>
<tr>
<td>1996</td>
<td>3,344</td>
<td>14,707</td>
<td>18,051</td>
</tr>
<tr>
<td>1997</td>
<td>6,029</td>
<td>18,600</td>
<td>24,629</td>
</tr>
<tr>
<td>1998</td>
<td>6,156</td>
<td>22,565</td>
<td>28,721</td>
</tr>
<tr>
<td>1999</td>
<td>7,181</td>
<td>27,209</td>
<td>34,390</td>
</tr>
<tr>
<td>2000</td>
<td>8,631</td>
<td>28,955</td>
<td>37,586</td>
</tr>
<tr>
<td>2001</td>
<td>10,697</td>
<td>27,985</td>
<td>37,985</td>
</tr>
<tr>
<td>2002</td>
<td>16,215</td>
<td>28,556</td>
<td>44,771</td>
</tr>
<tr>
<td>2003</td>
<td>18,908</td>
<td>35,390</td>
<td>54,298</td>
</tr>
<tr>
<td>2004</td>
<td>21,866</td>
<td>41,502</td>
<td>63,368</td>
</tr>
<tr>
<td>2005</td>
<td>22,714</td>
<td>43,903</td>
<td>66,617</td>
</tr>
<tr>
<td>2006</td>
<td>24,973</td>
<td>52,531</td>
<td>77,504</td>
</tr>
</tbody>
</table>

Source: Navajas and Gonzalez-Vega, 2000, and ProCredit El Salvador accounts

**Portfolio quality / management of external shocks**

Loan delinquencies reached 3-4% in the 1998-2000 period, but have been reduced in the last five years significantly and are now very manageable given the strict definition of loans overdue by just 30 days or more (see Table 5). ProCredit El Salvador furthermore reports to have written off yearly an average of only 0.7% of its urban and 0.95% of its rural portfolio in the years from 1998 to 2006. The institution has experienced a series of external shocks, none of which have seriously affected its rural portfolio: First, in 1998 Hurricane Mitch damaged some important production areas. Second, in early 2001 an earthquake damaged homes and disturbed the living conditions of about 20% of its mostly rural customers. Third, in 2002 and 2003 the producer prices of corn, sorghum and beans, which constitute an important income for the farmers served, were reduced by 20%.

As the portfolio quality figures show, the institution has been able to manage these shocks very well and, most remarkably, with very similar results for both its urban and rural lending. One of the main factors contributing to the successful management of risk in rural areas is the strong focus of the institution as a whole on
this issue. The institution’s rural lending technology, which focuses on the household as a unit with all its sources of income (as opposed to specific income sources), has proven to be a very valuable risk-mitigating tool. It contributes to the diversification of risk in ways similar to the patterns of risk diversification used by the customers themselves. Moreover, the institution has learned to manage external shocks by shunning a one-size-fits-all policy. Rather it assesses each affected customer’s situation individually and establishes tailored solutions (rescheduling, provision of additional funds, condoning of debt), depending on the capacity of each customer household to recover after an external shock. In the case of the earthquakes in 2001, for instance, ProCredit El Salvador rescheduled an estimated 10% of the loans in the severely affected areas and had to write off about 0.7% of its rural portfolio in addition to the average amount which is written off in normal years.

Table 5.

Evolution of urban and rural portfolio quality: Portfolio at risk over 30 days to outstanding portfolio at the end of each year (PAR 30), 1998-2006.

<table>
<thead>
<tr>
<th>Year</th>
<th>Urban Portfolio</th>
<th>Rural Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>3.5%</td>
<td>4.0%</td>
</tr>
<tr>
<td>1999</td>
<td>4.5%</td>
<td>2.8%</td>
</tr>
<tr>
<td>2000</td>
<td>4.5%</td>
<td>4.0%</td>
</tr>
<tr>
<td>2001</td>
<td>2.9%</td>
<td>3.3%</td>
</tr>
<tr>
<td>2002</td>
<td>2.6%</td>
<td>2.4%</td>
</tr>
<tr>
<td>2003</td>
<td>1.7%</td>
<td>1.4%</td>
</tr>
<tr>
<td>2004</td>
<td>1.4%</td>
<td>2.8%</td>
</tr>
<tr>
<td>2005</td>
<td>1.6%</td>
<td>2.2%</td>
</tr>
<tr>
<td>2006</td>
<td>1.6%</td>
<td>1.9%</td>
</tr>
</tbody>
</table>

Average 98 - 06: 2.7% 2.7%
Average 02 - 06 1.8% 2.1%

Source: ProCredit El Salvador accounts
Portfolio characteristics

As economic development occurs in rural areas, agriculture and livestock are losing importance so the loans repaid in rural areas with income from agriculture or livestock only constitute today about 42% of the total portfolio (Table 6). The very small average size of the agricultural loans (less than $500) reflects the poverty of the customers who make their living from this source of income. However, the relative importance of these customers in the institution’s overall portfolio (they represent almost 10% of all loans made) reflects the commitment of Banco ProCredit to serve this constituency.

Table 6: Breakdown ProCredit’s rural portfolio by economic sector as of December 31st, 2006

<table>
<thead>
<tr>
<th>Sector</th>
<th>Number of outstanding loans</th>
<th>Participation in total number of loans</th>
<th>Portfolio balance in US $</th>
<th>Average outstanding loan amount US$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>7,388</td>
<td>30%</td>
<td>3,472,397</td>
<td>470</td>
</tr>
<tr>
<td>Livestock</td>
<td>3,061</td>
<td>12%</td>
<td>5,773,425</td>
<td>1,886</td>
</tr>
<tr>
<td>Trade</td>
<td>8,246</td>
<td>33%</td>
<td>8,802,453</td>
<td>1,067</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>1,783</td>
<td>7%</td>
<td>2,279,589</td>
<td>1,278</td>
</tr>
<tr>
<td>Services</td>
<td>4,495</td>
<td>18%</td>
<td>7,891,154</td>
<td>1,755</td>
</tr>
<tr>
<td>Totals</td>
<td>24,973</td>
<td></td>
<td>28,219,018</td>
<td></td>
</tr>
</tbody>
</table>

Source: ProCredit El Salvador accounts

The data in Table 7 report an analysis conducted of rural and urban loan officers. Rather surprisingly, compared to urban loan officers, the rural officers on average have a slightly larger number of loans. Their portfolios, nevertheless, are smaller in monetary terms than those of their urban colleagues as a consequence of
the significantly larger urban loan sizes. Rural loan officers have proportionately fewer women clients as is expected in agriculture where enterprises tend to be family rather than individually based.

Table 7. Portfolio Indicators per Loan Officer as of December 31st, 2006

<table>
<thead>
<tr>
<th>Item</th>
<th>Rural Loan Officers</th>
<th>Urban Loan Officers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Median number of clients</td>
<td>320</td>
<td>289</td>
</tr>
<tr>
<td>Median portfolio</td>
<td>$362,000</td>
<td>$488,000</td>
</tr>
<tr>
<td>Median of loan sizes</td>
<td>$1,130</td>
<td>$1,686</td>
</tr>
<tr>
<td>Proportion of women borrowers</td>
<td>27 percent</td>
<td>73 percent</td>
</tr>
</tbody>
</table>

Source: ProCredit El Salvador accounts

Costs

Banco ProCredit’s diversified portfolio provides an opportunity to compare the cost performance of its rural and urban lending. Table 8 provides insights into the performance of ProCredit’s urban and rural branches. It compares the performance of three branches serving exclusively urban customers with the three branches with the highest proportion of rural loans in their portfolio (around 50%).

Table 8: Comparison of the performance of ProCredit’s urban and rural branches, January – November 2006 (Cost figures are annualized)

<table>
<thead>
<tr>
<th>Item</th>
<th>Urban Branches</th>
<th>Rural Branches</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average loan size</td>
<td>1,871</td>
<td>1,431</td>
</tr>
<tr>
<td>Income from loans / average loan portfolio</td>
<td>18.7%</td>
<td>19.8%</td>
</tr>
<tr>
<td>Direct operating costs/average loan portfolio</td>
<td>5.8%</td>
<td>6.2%</td>
</tr>
<tr>
<td>Direct personnel costs/average loan portfolio</td>
<td>3.6%</td>
<td>3.7%</td>
</tr>
<tr>
<td>Cost of loan loss provisions / average loan portfolio</td>
<td>2.9%</td>
<td>1.3%</td>
</tr>
</tbody>
</table>

Source: Own calculations based on ProCredit El Salvador Accounts
As can be seen, rural branches had smaller average loan sizes compared to urban branches, which stems from the very small size of the agricultural loans.

As shown in Table 8, urban and rural branches generate a similar income margin for the institution thus maintaining rural lending as an attractive business proposition for ProCredit El Salvador, especially considering the increase in competition that is occurring in urban markets among banks and MFIs.

The risk costs associated with rural lending seem to be quite well controlled: rural branches had in 2006 even lower loan loss provisioning costs than urban branches, continuing the tendency over the last years, according to which rural and urban portfolios have shown similar risk costs with small variations between years. In 2001 for instance, after the earth quakes, rural branches had provisioning costs of 6.7% (with respect to their average portfolio), while urban branches’ provisioning level was at 5.8%.

While similar operating costs may reflect the diversified operations of branches (which aside of lending also pay out remittances and accept deposits), they also reflect the high density of population in El Salvador, which is also high in many rural areas served by Banco ProCredit.

Type of households served

The issue of depth of poverty of ProCredit El Salvador clients was analyzed by Navajas and Gonzalez-Vega (2000) using results from the 1998 household survey. They found that 59 percent of the ProCredit El Salvador households were below the 1997 poverty line (about $520) and 34 percent fell below the extremely poor poverty line.
line (about $260). Clearly the organization was doing a good job in reaching poor people who were undoubtedly without commercial banking services.

Gonzalez-Vega, et al. (2002) interviewed a sample of 241 households that were clients of ProCredit El Salvador in 1999 and compared their characteristics with those obtained in a random sample of rural households. One of the objectives was to evaluate how representative the clients are of the general population. The socio-economic characteristics of ProCredit El Salvador households on average are quite similar to the national average in terms of household size and schooling. The clients are slightly younger and have a slightly higher percentage of women as household head. The potential household labor force of persons age 10 to 60, average number of persons employed, and household dependency rate are also roughly the same. However, the proportion of the labor force that actually works in the household is a bit higher among client households (75.7) than in the national sample (66.2). This might be due to a greater incidence of household enterprises. Likewise the number of persons in the household that migrated is slightly less.

The client households are a bit better located as measured by the minutes to primary school, to bus stop, to the closest market, and to the San Salvador metropolitan area. They also have greater access to electricity and piped water. The client households also tended to be a bit richer as shown by larger farm size, larger number of number of farm plots, larger number of crops cultivated, and larger number of types of animals raised. The largest difference was found in reported income. The clients reported an average per capita income of 10,500 colones compared to only 5,800 for the sample. This difference in income makes the client households
potentially more creditworthy than the average rural household, and this may explain why they are borrowers. It is also possible that borrowing contributed to increasing their incomes. When the sources of income of client households were analyzed, it was found that they often reported nonagricultural income, and for higher income households, this income was larger than agricultural income. Such households may be preferred by the loan officers because they have higher and multiple sources of income with which to make loan payments. Overall, however, the clients tend to be quite representative of the rural population.

POTENTIAL LIMITATIONS OF THE INDIVIDUAL LENDING TECHNOLOGY

ProCredit El Salvador has been successful in developing a flexible individual lending technology that is attractive to rural clients. The rural loan officers use it to reach levels of productivity that are sometimes higher than their urban counterparts, who operate in more competitive markets. The characteristics of the rural clients are similar to the average rural households, except that they may be a bit richer and earn higher incomes. This is consistent with a view that somewhat richer households will be more inclined than poorer ones to take the risk of borrowing.

These findings suggest that an individual lending technology can be effectively adapted for small rural loans in a poor, densely populated country. Farmers who are more favorably located may have a higher probability of being served but the technology is capable of serving clients who are quite poor in Salvadorian terms and very poor in international terms.
There may be situations in developing countries where it may be more difficult to use this individual lending methodology. For example, some type of group methodology may be useful in some situations where potential rural borrowers are even poorer so loan sizes must be even smaller, where population density is lower so distances between clients are greater, and risk is even greater due to production, marketing and climatic problems faced by farmers (Chao Berhoff, 1999). But group lending and member-owned financial institutions face a variety of governance and other problems not found in an institution like ProCredit El Salvador. These methodologies usually require high levels of group cohesion, and members must accept group responsibilities, higher transaction costs and more standardization of financial products.
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