Rural Finance: Savings Mobilization Potential and Deposit Instruments in Marginal Areas in Mexico.

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Financial services in Mexico's rural areas can be characterized as weak and unreliable. As a result of Government intervention and financial crises, financial markets in most rural areas have remained shallow and segmented. The rural poor, in particular, have been traditionally under-served not only with credit but even more so with deposit and payments services.

Directed credit at subsidized interest rates, subsidized credit guarantees, and debt forgiveness and restructuring characterized rural credit in Mexico during the 1980s and early 1990s. By the mid 1990s significant costs had resulted in the form of (a) excessive administrative costs and delinquency within public development banks; (b) widespread strategic default induced by disguised debt-forgiveness programs; (c) worsening income distribution resulting from interest-rate subsidies reaching unintended beneficiaries; and (d) regulatory problems and losses associated with special private organizations promoted to increase access to financial services in rural areas (the *uniones de crédito*).

The exchange-rate crisis of 1995 induced further closings of rural branches by struggling banks (including development banks), thus diminishing even more drastically the already dwindling presence of financial institutions in rural areas. At present, while countrywide bank density statistics have improved with respect to 1996, thanks in large part to the recent entry of foreign banks in the urban retail market, bank presence in the rural areas of Oaxaca and Huasteca is considerably below the country average, and only between one-fourth and on-sixth that of major urban centers.

Non-bank financial intermediaries (NBFIs), especially the "savings and loan" sector which showed some resilience to the financial crisis, have been burdened by serious regulatory and supervisory issues.[2] Moreover, the extent of their involvement in rural financial markets, and their potential to fill the service gap in rural areas was for the most part unknown.

Therefore, rural finance in Mexico confronts the challenges of: (a) developing institutional capacities that help overcome the shallowness and fragmentation of rural financial markets; and (b) resolving policy, legal and regulatory issues that impinge upon institutional capacity building. Reducing the dearth of knowledge that constraints informed policy-making and program design is where this study fits in the overall rural-finance picture.

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[2] "Savings and loan" is used to denote diverse cooperative financial institutions: *Sociedades de Ahorro y Préstamo* (SAPs), *Cajas Populares*, and *Cooperativas de Ahorro y Crédito*.

THIS STUDY

Recent Mexican Government efforts have been oriented towards finding policy and institutional solutions to the shortcomings of rural finance. This study contributes to that effort by deepening our understanding of financial markets in rural areas, and especially that of the role and potential of non-bank financial intermediaries. The study focuses on savings mobilization, where the knowledge gap appears to be the largest, and where conventional myths about the inability to save among the poor still prevail. It is in this area also where the study findings are likely to be most useful in the short run. In particular, the study findings and analyses will inform the on-going initiatives to reform the legal and regulatory framework for non-bank intermediaries (*entidades de ahorrro y crédito popular*). Operationally, the study will allow sharpening and enhancing the design and implementation of interventions in rural marginal areas.

The study meets the following specific objectives: (a) it documents and analyzes the extent and modalities of savings (physical and financial) practiced by rural households and enterprises; (b) it identifies and analyzes the factors that limit and help explain rural savings in financial form, on the demand side and the supply side; and (c) it sets forth guidelines for pilot interventions aimed at expanding sustainable savings mobilization in rural areas.

The study focused on predominantly indigenous areas classified as marginal in the Oaxaca and Huasteca regions. Two main data-gathering activities were carried out in the Cuicateca, Mazateca and Mixe zones of Oaxaca, and the Hidalgo, Veracruz and San Luis Potosí zones of the Huasteca: (a) a household survey, and (b) interviews with formal and informal providers of financial services.[3] In addition, a review of savings mobilization by non-bank intermediaries in Mexico, with a special section on the study areas was carried out in the Fall of 1999.

The survey sample frame included households as the unit of observation, in localities in all five degrees of marginality as defined by the *Consejo Nacional de Población* (CONAPO), within the regions indicated above.[4] Interviews were conducted in 118 localities with 2499 heads of households, plus 1629 separate interviews with their spouses, between August and October of 1999. Twenty five percent of the heads of household interviewed were women, who also comprised 96% of the interviews with spouses. About one-half of the heads of households interviewed were speakers of an indigenous native language.

The survey questionnaire was designed following a series of focus-groups discussions in the survey areas. These sessions provided valuable qualitative information on the

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[3] These areas correspond to those where the SAGAR/World Bank Marginal Areas Program was initiated in 1998, and where the Rural Microfinance TA pilot project (in preparation) will be launched. The sample frame, however, was expanded to include all five levels of marginality, instead of the three categories covered by Marginal Areas (medium to very high degree of marginality).

[4] The CONAPO calculates the Marginality Index based on seven socio-economic indicators grouped under three categories: education, occupation and housing. See Annex 1.

functioning of financial markets in these areas, and useful insights into the formulation and sequencing of questions.

The case-study interviews with providers of financial services included 28 informal intermediaries identified through local informants and survey respondents. In addition, twenty-one formal intermediaries were interviewed in the survey areas and nearby cities.[5] Excepting three branches of Banrural, all formal financial intermediaries were non-bank institutions.

Defining Rural Savings

Rural savings are defined here as the accumulation of financial and non-financial assets for future disposition in consumption or production. Financial assets may be held in a variety of forms: (a) formal, regulated financial institutions such as banks, some non-bank depository institutions (e.g., Sociedades de Ahorro y Préstamo, SAPs) and postal savings systems; (b) also formal (i.e., licensed under a law) but unregulated institutions such as *cooperativas de ahorro y crédito* and *cajas solidarias*; and (c) informal financial mechanisms such as rotating savings and credit associations (*tandas*), moneykeepers, savings groups and personal loans to others, all of which represent alternative means of holding financial assets for rural households, especially in areas not served by formal institutions.

Non-financial (physical) assets may bear little potential for transformation in liquid assets or financial savings (e.g., land, housing), or they may be close and imperfect substitutes for financial instruments (e.g., livestock and inventories). Indeed, the absence of adequate financial institutions has been associated with the tendency of poor rural households to keep larger sums of cash than needed, storing larger inventories of grain, and raising more livestock than they would otherwise maintain if they had access to deposit facilities.[6] Access to reliable depository institutions may therefore induce the monetization of these quasi-liquid physical assets, and the placement of surplus cash balances in safe deposit instruments.

The several motives households may have to save determine to a large extent the composition of their asset portfolio in terms of the main properties of savings instruments: liquidity, safety and return. Consumption smoothing in the face of seasonal income fluctuations, and reserves for emergencies will call for safe and highly liquid forms of savings, physical or financial, while planned events such as traditional festivities, lumpy investments and the beginning of the school year would require safe term instruments with higher return. The literature suggests that safety and liquidity, more than return, seem to guide the choice of savings instruments in rural areas. Nevertheless, diversity in the set of

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[5] For example, financial institutions in the city of Oaxaca were interviewed given their proximity to the Mixe zone.

[6] Robinson, Marguerite, "Savings Mobilization and Microenterprise Finance: The Indonesian Experience." In Otero, M. and E. Rhyne (eds.), *The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor*. Kumarian Press, New Haven, 1994.

deposit instruments is also important to match the different properties households seek when making savings decisions.

MAIN FINDINGS AND CONCLUSIONS

The findings and analyses presented here intend to support the following line of reasoning: (a) there is a considerable savings potential in rural areas seeking reliable financial instruments, especially safekeeping services; (b) providing these services would be welfare-enhancing in that it would help integrate the poor into the national economy, and it would reduce risks and improve returns associated with assets held by poor households; (c) an inadequate regulatory framework and market structure problems have weakened the supply of financial services in rural areas, and this failure may justify public intervention; and (d) service provision mechanisms inspired in international and domestic experience should be tested.

The supply side

This study finds that:

(a) Non-bank financial intermediaries have had an increasingly important role in Mexican rural finance in recent years as traditional government subsidized agricultural credit schemes have had a disappointing performance, and both commercial and public development bank presence shrunk in rural areas partly as a consequence of the 1995 crisis.

(b) Non-bank institutions, however, lack a solid legal and regulatory environment and reliable supervision, a factor that contributes to a high degree of institutional heterogeneity, and regulatory arbitrage. The diverse institutional types comprise a mix of well-run institutions and poorly-managed ones, few effectively supervised, most of them openly or *de facto* unsupervised, with large differences in performance and image *vis à vis* the general public.

(c) A systemic effect of this state of affairs is a generalized lack of confidence in the non-bank sector, which partially extends to the banking sector. At present, draft legislation in preparation *(Ley de Ahorro y Crédito Popular*) and, most importantly, its associated supervision mechanism are expected to allow the enactment and enforcement of prudential regulation thus far absent for a majority of the non-bank intermediaries active in rural areas. These reforms should help consolidate the non-bank sector into a reliable set of intermediaries that will gradually regain the confidence of the general public.

(d) From a savings mobilization perspective this study divided the non-bank intermediaries into two groups: (i) those that because of their scale and performance --such as the *Caja Popular Mexicana* (CPM)-- or their performance and implicit government backing –particularly, the *Patronato del Ahorro Nacional* (PAHNAL)--, are deemed trustworthy by the rural clientele but lack significant penetration in remote marginal areas; and (ii) those that do have such deep outreach, notably the *Cajas Solidarias* network, but offer little confidence to their regular or prospective clients as depository institutions due to weak performance and a legacy of a "grant mentality" associated with their role in government subsidized programs. *Cajas Solidarias* do, however, have a strong commitment to savings mobilization in poor communities, which sets them aside from other poor-performers such as the *uniones de crédito*, still for the most part neglecting deposit services.

Household participation in financial markets

Income sources: Non agriculture dominates. While a majority of the households indicated being primarily engaged in some agricultural activity (agricultural production, or farm labor out of the house), about one-fourth of the respondents had non-agricultural activities as primary occupations, notably a business (*negocio propio*) or non-farm labor. In terms of household revenues, this multi-activity translates into a predominance of non-agricultural sources of income for the average rural household. Moreover, as the degree of marginality increases the reliance on agricultural income also increases.

This has clear implications with respect to the desirable focus of rural development programs and to the inadequacy of "project" or activity targeting of agricultural credit. A broader focus that includes rural non-farm economic activities is needed to ensure comprehensive outreach to the poor. The survey findings suggest a relatively weak (inverse) relationship between marginality and income levels, although targeting high marginality areas does ensure reaching a large proportion of the poor.

Borrow informally and keep your money safe. Overall, households in the Oaxaca and Huasteca sample have a lower level of participation in financial markets than that reported in the 1995 Rural Finance study for parts of Guanajuato, Puebla and Veracruz. Access to formal credit is extremely low (2.5% of the sample) while use of informal sources (31%) is higher than that observed in the 1995 study.

Less than 6% of the households in the sample used some form of formal savings instrument. A revealing findings is that, in spite of the relative proximity of non-bank depository institutions, banks attract more formal depositors than these non-bank intermediaries. This is a clear reflection of a general lack of confidence in non-bank intermediaries, rooted in negative experiences in these regions and elsewhere.

Informal savings mechanisms are prevalent and important. Almost one-half of the households kept money at home primarily as a form of precautionary savings, and about 14% of the respondents had at least one other form of informal savings instrument (participation in *tandas*, use of moneykeepers or informal lending).

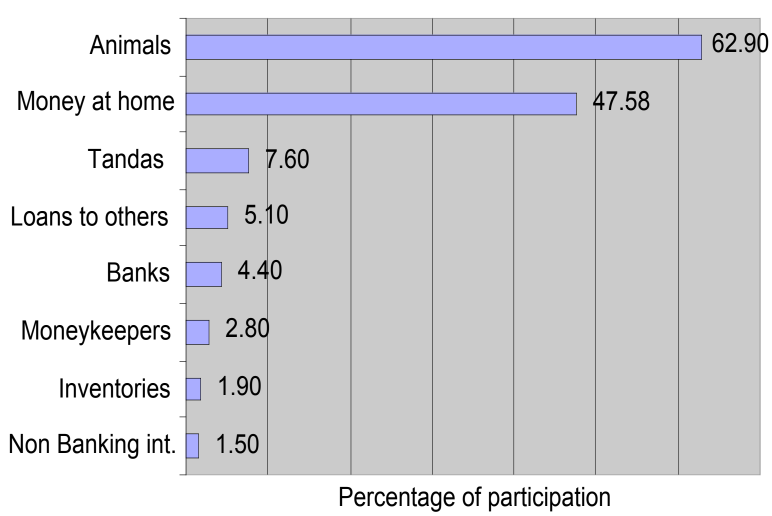
Physical assets, however, dominate the asset portfolio of rural households. Among these, physical assets classified as "high liquidity" (primarily livestock and inventories) represent about 56% of the total value of the asset portfolio (excluding land and housing), while the share of financial assets in this portfolio is 16.5% (7.1% formal, 9.4% informal). The value of livestock alone exceeds one-third of total assets (excluding the value of land and housing). On average, the value of high-liquidity physical assets is 3.3 times that of financial assets. This ratio increases as the degree of marginality increases, reflecting both different preferences for holding physical versus financial assets, as well as the different access communities have to reliable financial forms of savings.

Borrow informally, but keep your money safe, seems to be the behavioral rule most rural households in Oaxaca and Huasteca follow. They also are net debtors overall. Defining net financial position as financial assets *minus* financial liabilities, the average household keeps a positive net position in the formal market, and a negative one in the informal market. The overall net financial position is a negative balance. This pattern is on average true for both Oaxaca and Huasteca, and remains true for most levels of marginality. Across income levels, only the highest income quartile shows a positive balance. Overall debt as a proportion of annual income is the highest (6%) for the poorest income quartile.

The data analysis

The econometric analysis shows the factors that influence the choice of household assets, formal and informal. The use of different savings modalities is summarized in Figure 1, including the proportion of households in the sample that kept livestock. The explanatory variables are factors that pertain to the locality and household characteristics. A detailed description of the econometric models and their statistical results are included in the annex presented here.

Figure 1. Participation in different savings modalities, percent.



Source: Savings mobilization potential survey.

The probability of holding formal and informal financial assets (share in total assets) was found to be positively and significantly associated with households in more urban, less isolated localities, more educated, working in non-agricultural regular employment with stable income flows, and exposed to negative shocks. Being young and having a small family also increase the probability of savings in financial form.

Much like in the model used for all financial savings, the probability of savings in formal institutions increases with the education of the head of household and decreases among people who speak an indigenous language. Low marginality of the locality and the presence of a financial institution were also significant explanatory variables, reflecting the importance of the costs of access in the choice of this type of savings. Households that have never had a formal savings account tend to be in the more marginal areas, speak an indigenous language, be young and uneducated.

The annual average income and value assets of *tanda* participants are above the mean value of income and assets for the overall sample. The significant explanatory factors for *tanda* participation were similar to those found for formal savings: larger communities, non-agricultural employment, more educated and less aged heads of households.

People who use moneykeepers or informal lending are also above the average value of income and assets for the overall sample. The probability of engaging in this practices was negatively associated with the age of the head of household, and positively related to education. When the model was estimated using the measure of total assets that exclude land and housing, the probability of informal lending increases when a woman is the head of the household and when income levels are higher.

Holding cash at home is the most common form of informal financial savings, was practiced by households with average annual income lower than that of households with any of the modalities of savings previously discussed, but still higher than that of households with no cash savings. No major differences with the explanatory power of variables such as age of the head of household and locality size were found for this type of savings. Interestingly, however, this form of savings was negatively related to total household assets. When the model was estimated using the measure of total assets that exclude land and housing, the probability of holding cash at home increases when the locality is more marginal and among indigenous people.[7]

Overall, keeping livestock is the most prevalent single form of savings among the households in the survey. The predominant use of livestock was clearly as reserve for future sale or consumption. Only 10 percent of the households holding animals were using them for work (primarily horses and mules), and would only dispose of these in extreme emergencies. Otherwise, livestock was typically an asset reserved to generate income in the future. Sales of livestock were made to finance consumption or face unexpected expenditures. More than 80 percent of the sales were motivated by investment opportunities, schooling expenses, celebrations and festivities, emergencies and other reasons, while less than 20 percent of the sales were made because livestock raising was a line of business.

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[7] The focus groups findings revealed that indigenous women, especially in Oaxaca, keep money in a special hideout ("*escondite*").

In contrast with other forms of savings, households holding livestock had average annual income lower than that of households that do not have livestock. The econometric analysis of livestock holdings as a proportion of total assets showed that variables reflecting poverty and marginality are the ones with stronger explanatory power. A higher degree of marginality, lower household income, smaller localities with no financial institutions, older and less educated heads of household are all factors that increase the probability of maintaining a large proportion of total assets in the form of livestock. Having a large family and working in a non-agriculture activity also increase that probability.

In summary, savings in quasi-liquid physical form (livestock and inventories), was more likely in highly marginal areas, among the indigenous population and in large households. This type of savings is also more probable among households where primary activities are agricultural production and non-agricultural wage labor. Poor, illiterate people living in small communities are more likely to use quasi-liquid physical forms of savings.

Finally, a model was used to explain the condition of being a "pure saver", i.e., households that at the time of the survey had some form of financial savings (including cash) and did not have a debt of any kind. These "pure savers" represented 36% of the total sample and 64% of all households that save in financial form, formal or informal. People most likely to be in this category were located in less marginal communities, hence closer to institutions, and had higher household incomes and assets than individuals not in this class. Women and people of mature age are also more likely to be pure savers, a condition that may reflect biases against this type of clients in credit markets. Also, people keeping money at home had a higher probability of being pure savers. In this case, therefore, these households not only do not have access to credit but also do not benefit from the advantages of savings in formal financial forms. As in the first model, education, small family size and non-agricultural employment were positively associated with the pure-saver position.

An unsatisfied demand for deposit services

The survey suggests the existence of a substantial unsatisfied demand for formal savings services in the regions under study. Unsatisfied because important amounts are held either in informal financial instruments or in quasi-liquid physical assets, in the presence of a weak supply of formal deposit services.

As indicated above, while few rural households have access to formal deposit services, an important proportion of the households in the sample hold financial assets in informal mechanisms (primarily through holding cash at home, participating in *tandas* and lending to others). An even larger number of households keep savings in physical assets easily convertible into cash, especially livestock. Savings in all these forms amount, on average, to about 16% of average household income, a ratio comprised by 12.5% in quasi-liquid physical assets, 2.1% in informal financial assets and 1.6% in formal deposits.

Moreover, the informal means of savings that dominate in the households' portfolios are, at least in principle, clearly inferior to financial instruments. Informal lending, for example, suffers from a 20% "arrears/default-rate", while *tandas* report a 6% rate of non-compliance, i.e., group members who cease to contribute once they have taken their turn in the rotation. The most common forms of livestock holding, pigs and chickens, have mortality rates (i.e., loss rates) above 40%. One could argue, therefore, that given the opportunity (access) these rural households would be willing to transfer to, or gradually substitute over time, formal financial assets for informal savings, as long as the formal instruments resemble their traditional informal holdings but improve over these in at least one feature (liquidity, safety or return).

A number of questions emerge from the analysis: (a) does the presence of an unsatisfied demand mean that there is a market for deposit services in rural marginal areas? (b) would meeting this demand be a poverty-alleviation mechanism? (c) would meeting that demand be a sustainable proposition for formal financial intermediaries, and if so, what conditions would be necessary for this service provision to effectively meet the demand of rural households especially in terms of safety, and at the same time ensure sustainability of service providers in the long-run?

A market for deposit mobilization?

The survey shows that households rely on diverse sources of income, non-agricultural sources dominating over gross revenues from agricultural activities. Ability to save, albeit in small amounts, is not therefore tied to the cyclical patterns of crop production. In fact, in spite of most households being "net debtors" in the financial markets, small temporary surpluses abound and are kept at home, lent to others or contributed to *tandas*, while being accumulated for future lumpy expenditures.

The diversity of forms of savings is indicative of a demand for a range of deposit characteristics. Households have many different motives to save. Notably, traditional ceremonies and community celebrations, schooling, and productive investments involve lumpy expenditures usually met through some form of term savings. Livestock holdings, with a 4 to 6 month maturity, and to some extent informal lending to others with repayment in about 3 months, on average, tend to match these planned, lumpy expenditures. Liquidity, on the other hand, is valued by households to face unexpected expenditures without being forced to sell assets (typically piglets and chickens) at a loss.

What keeps formal reliable depository institutions from serving these areas? The short answer is that these areas are too poor to serve in a sustainable manner. the rural households in the survey regions, with average per capita income of about one-eighth the national average, may hardly represent in and of themselves a full market for a financial intermediary seeking sustainability. Even for the households in the highest income quartile, average per capita income is only slightly above one-third the national average. Moreover, only 20% of the households in the survey were above the international poverty line of US$ 2 per capita per day.

In other words, it would be unlikely for a financial intermediary relying *solely* in a rural marginal clientele to evolve into a fully self-sustainable institution. International experience shows that all well-known "best-practice institutions" in microfinance, have a meaningful share of their clients well above the poverty line. Moreover, research on rural non-bank financial intermediaries shows that the presence of middle-income clients in the NBFI portfolio helps sustain the intermediation costs associated with the poorer segments of their clientele, thus allowing a deep outreach while maintaining self-sustainability.

Why banks and large non-banks such as CPM do not establish services closer to the potential clients in rural marginal areas? This study submits that, while the fixed costs of establishing traditional branches in rural areas may be too high to justify *vis à vi*s the expected volume of business in these markets, less-traditional approaches to expanding outreach hold promise of sustainability at the margin. The "minimalist" agencies being established by PAHNAL under its current expansion program is one such approach worth considering for replication.

In summary, a broad, diverse scale of outreach would be necessary for any financial institution to maintain sustainability while mobilizing deposits in these marginal areas. Moreover, the observed preference for safety and for a range of maturities suggests that highly local, "micro" institutions more concerned with lending than with deposit mobilization would not be able to meet the households' demand for those deposit characteristics.

Meeting the unsatisfied demand would alleviate poverty

Conceptually, providing financial services in the region under study, as a means of integrating these communities into the national economy, is clearly a poverty-alleviation tool. The poor, as argued before, are able to save and do save. They build lump sums of money out of small and irregular income flows or, as evident in this study, out of storing quasi-liquid assets. International experience has shown that failure to save in financial forms among the poor is due primarily to lack of opportunity rather than for lack of will or understanding.[8]

In addition, this study shows that transforming informal, non-earning financial assets, and monetizing even a fraction of the savings held in physical form would have clear benefits in terms of return and safety. Moreover, since holding livestock as savings is more prevalent in poorer areas and among indigenous people than elsewhere, this kind of asset transformation would benefit relatively more the poorest segments of the population.

It is of course unrealistic to assume that all rural households will convert their existing physical assets into formal financial assets just by the mere appearance in the market of attractive deposit instruments. The presence of these instruments, however, is likely to influence subsequent savings decisions, as has been the case in experiences around the world. Attractive characteristics, according to the findings reported here, would be a near

[8] Rutherford, Stuart. *The Poor and Their Money*. Oxford University Press, Oxford, 2000.

total assurance of safety, a wide array of maturities and relatively simple, low-cost procedures.

Sustainable outreach to the poor - a test model

The proposal for a model or system of sustainable savings mobilization in rural marginal areas outlined here rests upon three basic principles: (i) the system has to inspire and effectively provide confidence to the general public; (ii) the system has to offer a broad range of deposit instruments in terms of maturity and return, reflecting in financial form the terms and conditions of, and with at least one advantage over, the traditional forms of savings prevalent in these regions; and (iii) the system needs to provide the services in a cost-effective manner for both suppliers and clients.

First, confidence is to a large extent dependent upon the legal, regulatory and supervisory framework under which intermediaries operate. As a long-term solution, the on-going efforts to reform the regulatory and supervisory framework for non-bank intermediaries (*entidades de ahorro y crédito popular*) should be encouraged and supported. While the new framework and supervision mechanism is likely to generate a healthy consolidation of the non-bank sector, it has the strong potential to significantly increase the number of trust-worthy financial institutions in Mexico. These efforts are key to reverse the crisis of confidence in financial institutions that contributes to explain the low participation of rural households in formal financial markets.

At present, aside from commercial banks, very few non-bank intermediaries are generally trusted by the public. Of those reviewed in this study, Caja Popular Mexicana (CPM) and Patronato del Ahorro Nacional (PAHNAL) seem to be the ones that pass the public-confidence test. The proposed system includes therefore commercial banks, CPM and PAHNAL as the guarantors of deposit safety.

Second, diversity of deposit instruments are offered in institutions such as PAHNAL with a "*tanda-ahorro*" instrument, but appears in general limited and driven by urban practices. Market studies and testing are necessary to identify new instruments that improve upon at least one of the terms and conditions of informal forms of savings.

In this regard, the study found revealed demand for: (a) fully liquid, instant withdrawal deposit accounts, like cash under the mattress but safer and with a high enough return to protect from inflation; (b) one to 3-month fixed term accounts, as in informal lending but with full recovery and some return (informal lending had difficult on-time recovery in 20% of the transactions and was almost always at zero interest); and (c) four to six-month term certificates of deposit, as in piglets and chickens but with no mortality. The array of deposit instruments currently offered by financial institutions, while abundant in basic savings accounts that would match the first type of demand, seemed deficient in short and medium term deposits (one to six months) that could replace informal lending and livestock holdings.

Remittances, received by about 15% of the households, and highly valued by those that do receive them, are a service where preference for formal services is at least as strong as it is in the case of deposits, the predominant formal means for remittances being the postal service. Informal means of receiving remittances were more costly, slower and less reliable than formal mechanisms. As it could be expected, areas of very high marginality used informal mechanisms more than twice as frequently as localities of very low marginality. In this respect, therefore, the importance of introducing reliable remittance services in institutions with deeper outreach is apparent.

Market experimentation and incentives to test new products should be a major component of the Rural Microfinance technical assistance. Participating financial intermediaries should be encouraged to include this feature, with specific market tests, monitoring and evaluation planned for the early stages of implementation.

Third, minimizing transaction costs of service provision and use is perhaps the biggest challenge on this proposed model. A two-prong approach seems required to attain this objective. On the demand side, assisting rural households to organize community savings groups, and to link these groups to strong, reliable financial institutions, especially banks and large NBFIs is clearly a step in the right direction.

On the supply side, technological and institutional innovations should be encouraged to link confidence with proximity and cost-effectiveness in the delivery of financial services in rural households. The institutions that inspire confidence, commercial banks, CPM and PAHNAL should be offered incentives to experiment in new delivery techniques such as smart cards, mobile units, and part-time regular services (e.g., once or twice a week in each community). Already existing practices such as opening small points of service on market days should be encouraged and even initially subsidized on a once-and-for all basis. Electronic solutions, which do not necessarily require the physical presence of the institution but can be located inside commercial retailers or post-offices should be tested.

Institutional linkages are also a potentially promising solution worth exploring. The pervasive presence of *Cajas Solidarias* and postal-service offices in remote areas could be exploited to serve as "certified agencies" of the trust-worthy institutions, i.e., PAHNAL, CPM or commercial banks. In this system, selected *Cajas*, evaluated, rated and regularly monitored by the regulated (principal) institution would collect deposits (as agents) from individuals or from the groups receiving social intermediation assistance as described above. The symbiotic arrangement currently in place between Banco Serfin (a commercial bank) and the Elektra stores provides an example of a functioning institutional linkage whose features could be extrapolated an tested among other institutional partners.

In summary, key elements of successful rural savings mobilization need to include:

- First and foremost, a strong effort to complete and perfect the reform of the legal and regulatory framework for non-bank financial institutions (*ahorro y crédito popular*). Not only the new legislation needs to be passed, but a simultaneous major investment in institutional capacity to evaluate and effectively supervise the institutions qualifying under the new law is essential.
- Second, capacity building for financial intermediaries expanding into rural areas needs to consider (a) the piloting of both innovative institutional arrangements and linkages

such as those suggested above; (b) the testing of deposit instruments that adequately reflect and improve upon the traditional forms of rural savings; and (c) the social intermediation services that enable rural households to knowingly and responsibly enter into formal financial transactions, as they become better integrated in the economy and meet their demands for savings and other financial services.

Box 1. The *Ley de Ahorro y Crédito Popular* proposal

The main features of the law proposal are: (a) the adoption of a functional approach to regulation, as opposed to the (traditional) institutional approach; (b) the introduction of a "self-regulatory system" and a delegated-supervision concept (*supervisión auxiliar*) as main components of supervision and control; (c) a deposit protection mechanism (not government-backed insurance).

The functional approach. The new law adopts the so called "functional approach" to regulation and supervision, which focuses on the functions/services performed by the entity, regardless of the institutional charter under which the entity operates. The law will therefore apply to institutions that "systematically and with priority" intermediate resources of the "popular segments" of the population, irrespective of their current legal charter. The most recent draft narrows down this definition to SAPs, UCs and *cooperativas de ahorro y préstamo*, requiring those entities operating under other legal charters to convert to one of those three legal forms. Entities that do not submit to the new law will be required to cease deposit-movilization activities.

The proposal recognizes four "levels of sophistication" for the EACPs, each level defining the scope and scale of the EACP and specifying the operations allowed by the law on both sides of the balance sheet.[1] Prudential rules for EACPs are specified in the proposal differentiated by the "level-of-sophistication" category.

Self-regulatory bodies and delegated supervision (supervisión auxiliar). Perhaps the most difficult part of the proposal, the law will require all EACPs to join a Federation, specifically authorized by the law to exercise the roles of "organizing, promoting and implementing a self-regulatory scheme of the EACP sector". The federations in turn may form a "confederation" with supervisory functions over the federations. The confederations, and the federations not affiliated in confederations, will be under the direct supervision of the financial authority.

The federations will carry out the regulatory and auxiliary supervisory functions determined by the law, a responsibility delegated to them by the authority. They will approve the entry and exit in the regulated system (since joining a federation will be mandatory for all EACPs), and will carry out the delegated supervision of the EACPs in accordance with their "levels of sophistication".

Deposit protection. The proposal establishes a deposit protection mechanism for (net) deposits of less than 10,000 UDIs (about 27,700 pesos of May 2000). This mechanism would be funded by the EACPs (it is inspired in the German model of deposit protection funds) and no government backing is anticipated.

Issues to consider.

Political support. The proposal seems to have broad political support. As a result of the interactions between the working group and stakeholders, several partial proposals presented by isolated interest groups have been withdrawn or put on hold.

Implementation. A critical aspect of the new law will be the ability of government to effectively implement the new regulation and supervision. Setting up and tooling up the federations and confederations promises to be a major undertaking. It would be advisable to pilot this delegated-supervision mechanism in one or two states before a large effort is launched.

Consolidation of the sector. The new law has the potential to induce a healthy and much needed consolidation of the non-bank sector, while helping strengthen the EACPs that enter and stay in the system. How to deal with those that do not enter, and help the remaining ones to cover the market is another matter to consider in subsequent work and dialogue.