FROM IDEALS TO INSTITUTIONS:
Institutional Entrepreneurship in Mexican Small Business Finance

by

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Submitted to the MIT Sloan School of Management
in partial fulfillment of the requirements for the degree of

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at the

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June 2008

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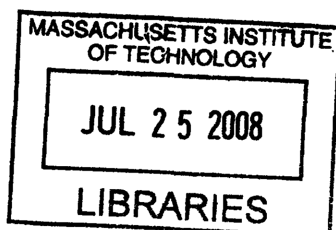
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ABSTRACT

Through a combination of in-depth research and unique loan-level data, this dissertation explores the mechanisms of intentional institutional change. It argues that current accounts of institutions and institutional change require but do not provide a systematic understanding of the role of individuals in processes of change. It then uses two in-depth case studies to explore the mechanisms through which individuals can initiate institutional change. One case is the activation of the small business credit market in Mexico. The second is the expansion of microcredit in the country. Through these cases, the dissertation proposes that, contrary to conventional thinking, institutional change is not rare because institutional entrepreneurs are scarce. In fact, they are quite prevalent. Rather, what is scarce is the required combination of an opportunity for change, individuals who can recognize this opportunity, have the capabilities and skills to pursue it, and are situated in the right structural position to drive a change process. It further argues that successful institutional entrepreneurs are usually situated in positions of middle management, which provide the right balance between a motivation to experiment, access to sufficient resources, and discretion to diverge from norms. Additionally, institutional entrepreneurs tend to have mixed backgrounds with diverse professional trajectories, which allow them to detect opportunities, cross borders, and learn the different languages required to brokerage experimental efforts.

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Introduction

From Ideals to Institutions:

Institutional Entrepreneurship in Mexican Small Business Finance

Introduction

This dissertation begins, as many such works do, with an impossibly broad question: What makes intentional institutional change possible? That is, how can actors who are immersed in an institutionalized setting purposefully change it?

The question is important, because institutions not only are pervasive constitutive elements of social life but also are at the heart of many social desirable outcomes, such as economic development. At the same time, the question is theoretically difficult, because institutions are in fact defined by their stability, derived from broad convergence on what actors within a system deem as acceptable courses of action. Such convergence is reflected in different layers of institutions such as laws and regulations, organizational practices, and even in the beliefs of individuals to the extent that, in their mature state, institutions become taken for granted and are no longer questioned. But if convergence is happening on all these levels, then where can divergence possibly come from? That is, if it is indeed the case that institutions become so ingrained that they affect what individuals can even conceive of, then how can actors who have been socialized into an institution envision an alternative course of action? And how would such an alternative become, in turn, institutionalized?

As an illustration –covered in depth in chapters 3 and 4 of the dissertation—consider Small and Medium Enterprise (SME) credit in Mexico. The Mexican financial sector is largely underdeveloped, Mexico is considered to be one of the worst business financing environments in the world, and it has been so for decades. This is partly due to a dysfunctional property right regime, inefficient courts, and highly restrictive legislation on lending activities. SMEs as a segment have been particularly neglected and hard hit by the lack of financing. Up to 2001, the country's strongest financial players –the national banks—did not consider SMEs to be a viable segment, viewed firms as unacceptably risky and not credit-worthy, and were averse to providing business credit to the point of not even having the organizational capabilities to perform SME credit analysis. The

common view among bankers is summarized in the following quote from the credit director of one of the largest banks:

> "I can see no reason to lend to SMEs. We meet our lending targets by lending to the government, as well as large clients (...). We make enough money through those loans and commissions. Why would we ever lend to SMEs? Just the complexity of analyzing each loan would make it a nightmare. And given that we don't know the segment well, we don't even know if they will repay us!"

SMEs, for their part, did not hold a much different view. They did not think of themselves as credit-worthy, given their lack of familiarity with credit they did not know how to handle (or even apply for) a loan and, as a result, they did not consider bank financing as an alternative. The following quote from a steel distribution business owner illustrates this clearly:

> "I have not (considered applying for a bank loan). The banks don't lend money. But even if they did, it would cost me a lot. My supplier credit does not cost me. Also, if for some reason I fall back on my payments, they would come and take my house away. I don't need that."

It is interesting to note that, in fact, trade credit (supplier credit) to SMEs in Mexico carries a cost of between 100 and 150 percent per year. The fact that it is built into the price of goods and that it has become the de facto way of operating, however, has made business owners like the one above not even consider it as a financing cost anymore. What we observe before 2001 then, is a highly institutionalized system where laws and regulations, organizational practices, and mental frames had converged around a poor institutional outcome.

Four years later, the situation was practically reversed. After investing only $150 million of government funds in a government program–a small amount in a country the size of Mexico—close to two hundred thousand SMEs had received more than $4 billion in bank credit. By 2006, all of the major banks in Mexico had an area exclusively devoted to SME credit and several of them considered SMEs as their priority segment to develop. Legislative changes were passed improving collection procedures and easing the restrictions on SME lending. SMEs were also demanding credit at never before seen rates. The change is clearly dramatic. But how could such a small program, launched by

officials in the Ministry of the Economy who had relatively little power within the governmental structure, stimulate such a widespread change in such a short time? And more broadly, how are institutional changes as extensive as this one possible?

Existing literature provides an answer: Certain individuals, or institutional entrepreneurs, can bring divergence to institutionalized systems by experimenting with new courses of action. When those experimental efforts succeed, change can occur as other actors imitate and replicate divergent practices. The way this is typically documented is through the description of a successful institutional change (by definition rare), where the actions of the person (or people) that seem to have generated change are traced back from the end point. In these descriptions, institutional entrepreneurs seem to follow a relatively linear path, given that change processes are recounted retrospectively. At the same time, given that institutional change so seldom happens, the image we are generally left with is one of institutional entrepreneurs as extremely rare occurrences, where their scarcity is at least partially accountable for the rarity of institutional change. As I argue in this dissertation, such accounts are problematic on two levels. Empirically, they suffer from survivorship bias. That is, because they start from a successful change and only trace back the successful and recorded actions that observed institutional entrepreneurs took, we do not know whether other unobserved actors performed similar actions but were unsuccessful, or whether unreported actions of the observed actors could have also accounted for the success. Consider, for example, traditional business entrepreneurship. Only a small fraction of business entrepreneurs are successful in starting a business, even though many try; and success is not necessarily determined by individual skill. Moreover, both successful and unsuccessful attempts are recognized as equally instructive instances of entrepreneurship.

On the other hand, even if observed actors were indeed fully responsible for a change, and even if their recorded actions were the true cause of that change, there remains the theoretical problem of where the institutional entrepreneurs' ideas for divergence originated. Put differently, if institutional stability is the result of convergence in beliefs

of what are acceptable courses of action, then how can an actor who has been socialized into an institution conceive of a divergent path?

This apparent paradox is resolved by the fact that institutions are maintained by the convergence in *public* beliefs, while broad divergence in *private* beliefs may exist. That is, public –or second order beliefs—are what individuals think most other people believe. Private –or first order beliefs—are what individuals actually believe. There are two important clarifications. The first is that these two types of beliefs need not be perfectly aligned, which means that, at any point in time, alternative possibilities may be envisioned by many individuals within a stable system. The second is that divergence from norms entails uncertainty in results and risks of reprisal. As a result, and due to pluralistic ignorance –or the fact that an individual with divergent beliefs never knows how many other people would agree with her—actors keep their divergent beliefs in the private realm and thus maintain the status quo. In consequence, even though alternatives can be envisioned by many, only public beliefs can typically be observed. The implication is that, at any point in time, there could be many potential institutional entrepreneurs with different ideas on how to change an institution but who are not typically observable.

In a world where multiple, if potential, institutional entrepreneurs are present, the question is no longer how individuals can envision alternative possibilities. Rather, the question becomes under what conditions these individuals will choose to act upon their divergent ideas to experiment with new practices, and when they will succeed in their change efforts. This is the narrower (but admittedly still impossibly large) question behind the present work. Within the context of small business finance in Mexico, I use two empirical cases to explore different aspects of the question. In particular, I use the creation of the small business credit market to show how individuals across different organizations coordinate as they face roadblocks in the path to institutional change, as well as the mechanisms that allow some of them to successfully overcome them. Later, I use the case of microfinance –more specifically, three microfinance companies—to show how, within an organization with well established structures and rules, competing logics

can coexist and how certain conditions enable some individuals to act upon their divergent logics. In what remains of this introduction, I will provide a brief outline of the dissertation, describing broadly what each of the chapters attempts to do and the key insights that emerge from them.

Outline of the Dissertation

The dissertation is structured into two sections. Section One –composed of Chapters 1 and 2—presents the theoretical and empirical setup for the work, while Section Two – Chapters 3, 4, and 5—delves into the empirical cases to provide theoretical insights.

Section One. Setting the Stage

Chapter 1 provides a broad survey of existing literature on institutions and institutional change. Using the "Three Institutionalisms" framework, it divides existing literature into Rational Choice, Sociological, and Historical Institutionalisms and it dissects the different mechanisms that each school proposes both for institutional stability and for change. This focus on micro mechanisms highlights not only the key contributions of each school to our understanding of change but also the key assumptions, shortcomings, and contradictions that emerge from each framework. In so doing, the chapter shows how each school has made assumptions –explicit or implicit—about the role of individuals in initiating institutional change but none of them has developed a systematic understanding of when we should expect institutional entrepreneurs to emerge and we should expect them to succeed. In addition, the chapter builds on existing literature to lay out the key barriers that a potential institutional entrepreneur would face in her path to change and the types of resources and activities that would be necessary to initiate it. Accordingly, the chapter lays the theoretical roadmap that guides the rest of the dissertation.

Chapter 2, in turn, provides the justification for the Mexican financial sector as a research setting. The chapter describes the institutional and historical characteristics –as well as the recent developments—that establish Mexico as a critical case with certain

particularities that make it an especially fertile ground for the study of institutional change. In particular, the chapter describes the historical developments of the financial sector (such as its centrality in the Mexican polity and its complex love-hate relationship with the government) that have both made it the worst performer amongst OECD countries –and one of the worst in Latin America—and particularly resistant to change. It also shows how, in this context of backwardness and resilience to change, two remarkable developments emerged, both of which present unique characteristics that make them attractive research cases.

The first, as mentioned above, is the creation of the SME credit market, which has several unique aspects. First, it illustrates the creation of a market in a context where all the cards were stacked against it and where several previous efforts had failed. Second, the factor that detonated its creation was a relatively simple government program, consisting of a guarantee operated through the national banks called the national financing system (SINAFIN). The program is remarkable both in its simplicity and in the fact that less than $150 Million of government funds detonated more than $4 Billion in credit. In that sense, it is not a case of simple policy implementation; rather, it is a case of a series of minor events detonating a large and widespread change. Third and related, while the program was launched centrally by the federal government, all large banks and all state governments were invited to participate in its design and early implementation, but only certain banks (three) and certain state governments participated actively. As a result, there are wide variations both in the practices followed and in the results achieved by different banks and states, all under the same central underlying structure. Accordingly, it constitutes a natural experiment where successful and unsuccessful efforts of institutional can be matched and compared and where insights about the mechanisms that render some efforts successful can be discovered.

The second development is the explosion of microfinance in Mexico. In line with other developing (and many developed) countries, Mexico experienced dramatic growth in microcredit during the 1990s. At the same time, given the institutional intricacies of the country, the Mexican microfinance sector is argued to present a 10 year lag with respect

to other countries in the region. The combination of a large potential market with the tardiness in its development creates a series of distinctive features. First, by the time microfinance began to seriously develop in Mexico, there already existed a relatively narrow set of international best practices that microfinance institutions (MFIs) were expected to follow. These practices were transferred through donor and international development agencies that saw microfinance as a vehicle to reduce poverty. Second, pioneering MFIs in Mexico started to develop in the mid nineties, which coincided with a deep country-wide financial crisis. As a result, and given that MFIs depended heavily on donor funds, Mexican organizations had to draw upon international donors, which put additional pressure on them to incorporate international best practices in lending rules and structures. Third, at the same time that Mexican MFIs were pressured to incorporate these best practices, they faced considerable market and regulatory uncertainty in their daily operations. This combination of factors, together with the nature of microfinance where most lending decisions must be made at the street level, brings to light the potential contradictions that may exist between formal structures and actual organizational practices and how these contradictions may lead to the coexistence – within the same structure and rules—of differing logics of action that may result in diverging organizational practices. As a result, Mexican MFIs proved to be fertile grounds to understand the mechanisms through which diverging private mental models can coexist and how, under certain circumstances, they may be brought into the fore.

Section Two. Empirical Cases

In the second section of the dissertation, the two empirical cases are developed in depth, explaining the methods used to analyze them, the data collected, and the findings that emerge from them. The two empirical cases share several similarities. They both occur within the Mexican financial sector, even if they span different aspects of it. In addition, similar methods were used to analyze the two cases. In particular, given the nature of the phenomena of interest, both cases use a mixture of qualitative and quantitative data that span different levels of analysis. That is, this work is concerned with the mechanisms through which institutions operate and change. Accordingly, it analyzes how macro

structures affect human behavior and interactions at the micro level, and how those interactions end up affecting the macro level. Both cases also follow a natural experiment set up, where the same central structure yields varying results in an outcome of interest at a lower level of analysis. Table 1 shows the similarities and contrasts between the two cases.

Table 1.- Summary of Dissertation Case Studies

	SINAFIN	**Microcredit**
Levels Spanned	• Federal • State • Organization	• MFI • Branch • Loan Officer
Dependent Variable	Market Activation	Performance of Loans
Variation	• Across states • Across organizations	Across branches
Constant	Program Structure	MFI Structure
Qualitative Interviews	200+	100
Quantitative Data	All SME loans	MFI's loans
Fieldwork Time	1.5 years	5 months

It can be seen that both cases straddle three different levels of analysis and combine extensive in depth qualitative work with quantitative data. What is different between them, however, is that the case of SINAFIN analyzes a nation-wide transformation, which entails straddling the federal-state-organization levels of analysis, while the microcredit case analyzes how rules are actually enacted in daily practices and thus straddles the organization-branch-loan officer levels. An additional difference between the cases, which is related to the scale of the phenomenon they present, has to do with their size and ambition as research projects. That is, the SINAFIN program initiated the creation of a national market for SME credit, which entailed the participation of several national banks, state governments, national NGOs, the legislature, and the federal

government. It created deep institutional transformations that are likely to alter the path of the entire financial sector and, arguably, the economy. The case study sheds light on the process through which individuals generate such broad transformations and is therefore very ambitious in its scope. The microcredit case, for its part, only analyzes three MFIs and the internal contradictions generated between their formal rules and their operating environment. While the case study sheds light on the important issue of how conflicting or divergent logics of action can co-exist –which addresses the central question of whether multiple potential institutional entrepreneurs actually exist—it is nonetheless clearly less ambitious in its scope.

In that sense, it is useful to think of the two cases as addressing different pieces of the broader puzzle of individual action and institutional change, where the microcredit case looks at the mechanisms that explain the preconditions for institutional entrepreneurship as well as the internal organizational dynamics that create them, while the SINAFIN case addresses the broader question of how institutional entrepreneurs actually detect broader opportunities for change and mobilize to address them. Given their differences in scope and ambition, then, the cases do not occupy equal space of the dissertation. Chapters 3 and 4 focus on SINAFIN, while Chapter 5 presents the microcredit case.

SINAFIN and Institutional Entrepreneurship

Chapter 3 presents a chronology of the SINAFIN as a government program from its initial design stages to the time of this analysis in 2006. It describes the different design stages it went through and the various transformations it suffered from its inception. The chapter highlights the experimental nature of the program, where several alternatives were attempted at each design stage. It also underscores the collective nature of the program and the broad changes it generated in the marketplace as well as within different organizations. In addition, the chapter presents the actual results achieved by the program and analyzes its impact at different levels. Finally, it discusses the program's characteristics as a public policy, the best practices that surfaced in certain states, and the broader lessons it presents for policymaking. In particular, Chapter 3 argues for a new approach to policy-making, where it is thought of more as an experimental process of

learning than an impossible quest for the "right" incentive alignment and where policymakers function as coordinators of and conflict mediators between different social actors instead of as "oracles" that must come up with the right answers.

Chapter 4 analyzes SINAFIN as a process of institutional change, and delves deeper into the mechanisms that allowed certain individuals, and not others, to successfully initiate this broad process of transformation. The chapter first proposes that, in order to disentangle the mechanisms of institutional entrepreneurship, it is important to think of it not as a linear process that can be traced back from success to initiation but rather as a *sequence* of *relatively unlikely* events, *all* of which must happen in order for change to succeed. In other words, it proposes to start the analysis with a full risk set of potential institutional entrepreneurs –instead of the individual or individuals who actually succeeded—and analyze the process through which some of them actually become entrepreneurs who succeed, others fail in their attempt, and others still never attempt change at all. This sequential model of institutional change –inductively derived from the qualitative work described above—provides the backbone for the exploration of the mechanisms of institutional entrepreneurship, and guides the entire chapter.

The stage model (summarized in Figure 1) proposes that, for an individual to purposefully initiate institutional change, she must first detect an opportunity for it and, once detected, she must be *willing* to incur the costs (and risks) involved in the creation of new alternatives. In addition, she must be *able* to initiate the change. That is, she must mobilize enough resources and generate consensus between different groups to engage in experimentation. Finally, she must disseminate positive results to begin the institutionalization of new practices. At each of the different stages of change, individuals encounter specific barriers that need to be overcome, and only some have the personal qualities and are situated in the right structural positions to overcome them.

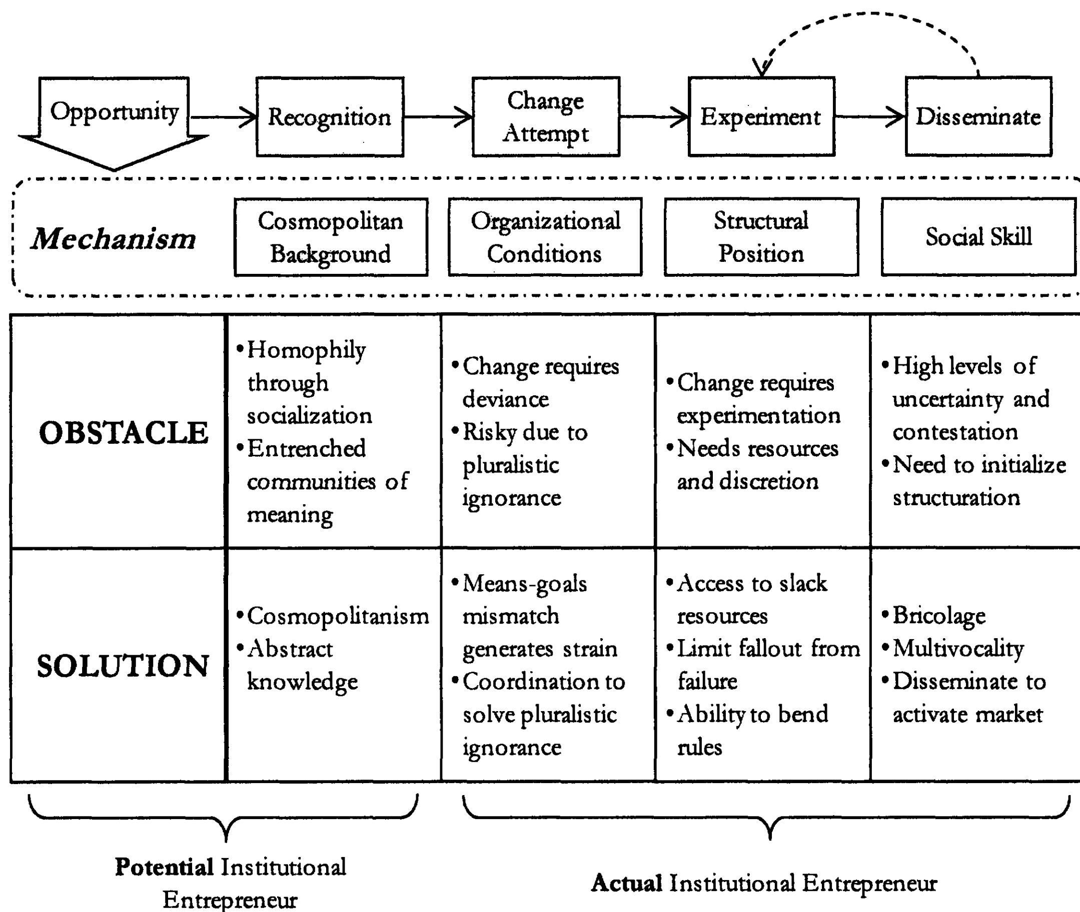
In particular, certain individuals, due to their diverse professional background, become cosmopolitan (in the Simmelian sense) and develop the cultural toolkit that allows them to bridge otherwise isolated and entrenched communities of meaning. They thus manage

to circumvent the homophily generated by natural socialization processes. These cosmopolitan actors can therefore detect opportunities for change where most others can only envision the status quo. At the same time, recognizing an opportunity for change does not necessarily mean that a person will be willing to pursue it. Institutional change, by definition, entails deviating from norms which can result in incalculable personal costs. In addition, given that it entails moving in unchartered territory, there is much uncertainty in the potential benefits of new practices. Accordingly, individuals must have the willingness to deviate from norms and must have some assurance that the potential personal costs will be at least limited. In the case of SINAFIN, the initial stages of the program provided a coordinating device –in the form of a long series of roundtables— that allowed potential institutional entrepreneurs to clearly identify each other –thus solving the issue of pluralistic ignorance—and engage in collective action to challenge existing conceptions, legitimize their efforts, and limit the potential downside. In addition, a common characteristic of the individuals that decided to engage in change efforts was that they not only recognized the large opportunity for change, but also that they experienced large levels of organizational strain (in the Mertonian sense) that created the motivation to initiate change through experimentation. These organizational conditions, then, created in certain individuals the *willingness* for change.

This willingness to generate change, however, does not constitute the *ability* to carry it through. That is, not all the individuals who decide to attempt a change can actually instigate change efforts. In fact, quite the opposite is true. Because of the uncertainty that surrounds a potential institutional change, experimentation is a crucial component of change efforts. Actors who are socialized into an institution and who have a vested interest in the status quo are likely to find the proposition for change threatening and unconvincing. Experiments that can show that alternative practices produce successful results can greatly reduce uncertainty and mitigate resistance to change. For example, to convince fellow bank employees that SME lending is, contrary to their belief, an attractive opportunity, a manager would need to show evidence of her claim by, ideally, granting a loan to a sample of SMEs and showing that repayment and profit rates on those loans are healthy. Note, however, that organizational experiments such as this one

require significant amounts of resources (in this case, money for loans as well as people to grant them, collect them, and manage them). They also require bending or breaking the rules that bar such activities. A fine balance must then be struck between having access to resources and the discretion to bend rules, and such a balance can only be found in certain positions of the organizational structure. In the case of SINAFIN, for example, all successful institutional entrepreneurs were situated in a position of middle management, and the mechanisms for this are further explored in Chapter 4.

Fig.1.- The Mechanisms of Institutional Entrepreneurship



Finally, once institutional entrepreneurs manage to create successful organizational experiments, it is necessary to aggregate successful results and disseminate them widely, in order to begin the process of institutionalization of new practices. Social and political skill play a significant role here, as actors must defend their experimental efforts against

potential contestation; must have the ability to aggregate, interpret, translate, and present successful results in a convincing way; and must have the ability and sensitivity to disseminate results as needed, which entails broadcasting them with varying intensity depending on the maturity of the process.

What emerges from the chapter, then, is a starkly different view of institutional change through entrepreneurship. The chapter shows that institutional change is not rare because institutional entrepreneurs are unique or scarce. Rather, it is rare because it entails a sequence of unlikely events which, in turn, require a very fine balance between the ability to detect an opportunity, the structural position to mobilize resources and bend rules around it, and the social and political skill to initiate the institutionalization of new practices.

Microcredit and Change through Deviance

Chapter 5 analyzes three Mexican MFIs to explore, in more detail, two specific aspects of institutional dynamics. The first is the coexistence of alternative –and possibly conflicting—institutional logics or, put differently, the existence of private beliefs that diverge from established norms. The second and related is how, under certain conditions, these diverging private beliefs will lead to deviant behavior which, in turn, may end up transforming broader norms. The chapter looks *within* these MFIs and leverages variation found across branches of each of them to show how, under the same set of centralized rules, actual organizational practices diverge significantly. In particular, it focuses on loan officer and branch manager practices, how they develop and, more importantly, how they affect lending outcomes. The chapter explores the nature of microlending, where lending decisions must be made by loan officers in direct interaction with clients, and where the vast uncertainty in outcomes faced by loan officers is impossible to thoroughly anticipate in operational rules.

In this context, that mirrors the characteristics of Michael Lipsky's "Street-Level Bureaucracies", a broad typology of loan officers emerges. One type of officers (named "Letter of the Law") addresses the uncertainty faced in their daily work by adhering

strictly to rules that limit their own discretion. The other type (named "Spirit of the Law") follows typical street-level bureaucrat behavior in the sense that they think of rules as tools to perform their work more effectively, rather than as binding constraints that should not be questioned. These officers leverage their intimate knowledge of their clients and context, take full advantage of their organizational discretion, and consistently bend rules in their interactions with clients in pursuit of better loan performances. The differences in practices become especially salient –but are also present in many other instances—in the way loan officers react to client defaults, where the rules state that loans *must* be collected upon strictly. Surprisingly, "Spirit of the Law" officers, who consistently bend rules, tend to systematically outperform "Letter of the Law" officers, who follow organizational rules strictly. This is surprising given that, as I described above, MFI structures and organizational rules were derived from long standing international best practices. It is also surprising to find that these differences in behavior and performance are repeated across MFIs with different lending and organizational structures.

The chapter argues that these different types of behavior can coexist because they emerge from fundamentally different conceptions of what a loan officer's work is and what behavior is to be expected of clients. The mental models are further sustained because, in the interaction with clients, they generate "self-fulfilling prophecies", become self-reinforcing, and are thus perpetuated. For example, a client who defaults on a loan because she faced a personal difficulty can become a terrible client if a loan officer seeks to collect strictly by confiscating her productive assets. The same client, however, can become an outstanding and committed client if the loan is restructured and she is helped through her struggle. The chapter also shows how, under certain conditions that generate strain –such as when the application of a rule is perceived as gravely unfair, deviant behavior is initiated by "Spirit of the Law" officers. It also shows how, when these deviant acts achieve positive results, the behavior is imitated throughout the organization to the point that managers feel the pressure to change existing rules so they can officially sanction the practices.

Together, these two empirical cases developed in Chapters 3 to 5 present a more nuanced view of the mechanisms through which institutions constrain but also enable individual action which, in turn, can greatly affect institutions. They both shed light on different aspects of the role of individual actors in perpetuating institutions but also, and more importantly, in initiating institutional change. They also show that diverging logics of action, institutional entrepreneurship, and institutional change are actually systematic and constant occurrences of institutionalized systems. Accordingly, they show that change is an intrinsic, if complex, element of institutional structures. This view of institutional entrepreneurship as a common and pervasive phenomenon contrasts starkly with traditional views where institutional entrepreneurship is portrayed –explicitly or implicitly—as an extremely rare occurrence.

More broadly, this dissertation seeks to deepen our understanding of the role of individual actors in generating institutional change. It attempts this through theory grounded in the observation of individuals who, in their daily struggles and interactions, and in their quest to improve their organizations –or often to simply "do their job well"—face the daunting challenge of breaking through norms that they believe are flawed. The work delves deeper into the issue of agency in institutional change in two additional ways. First, it seeks to go beyond the theoretical conception of where agency *may* matter and truly puts a face, a name, and a story behind the individuals who gradually but persistently generate broad social changes. At the same time, it does not focus on the last standing actors and therefore avoids a messianic or heroic view of institutional entrepreneurship. In that sense, it is an attempt to focus on the true heroes of institutional change: the array of actors whose covert efforts combine and aggregate to eventually precipitate change; who in most cases fail at their attempts with serious personal and professional implications; who, more often than not, become casualties of their own (unlikely) success; and who, in the few cases where change succeeds, are rarely the last standing to tell the true story of change. This work seeks, however humbly, to give them a voice.

Chapter 1

The Mechanisms of Institutional Change: Bringing Agents (back?) In

Introduction

Research on the role of institutions in economic development has reached two solid conclusions: First, institutions matter a great deal. Institutional environments constrain and channel economic activity and in so doing determine the path that a country will follow in its development (Johnson et al. 1999; La Porta et al. 1999; Johnson, McMillan et al. 2000; Acemoglu et al. 2001; 2002; Rodrik 2004; Forthcoming). Second, institutional change is hard. Institutions develop as complex systems of interlocking and complementary written, unwritten, and taken-for-granted norms that are mutually reinforcing and display remarkable resistance to change (North 1990; Berger and Dore 1996; Immergut 1998; Acemoglu et al. 2001; Hall and Soskice 2001).

The disciplinary diversity that the study of institutions has attracted has obviously generated an array of definitions of what an institution is. For this work, and because I do not seek to engage in that particular debate, I will adopt a general definition of institutions.

> "Institutions exert patterned higher-order effects on the actions, indeed the constitution, of individuals and organizations without requiring *repeated* collective mobilization or authoritative intervention to achieve these regularities." (Clemens and Cook 1999 : 445, emphasis my own).

Given the complexity and centrality of the phenomenon, there is still a debate on which particular institutions are more conducive to economic development, and, within those institutions, which should take priority. In fact, there only seems to be relative consensus that the most critical institutions are those that promote property right protection and contract enforcement (La Porta et al. 1997; Johnson et al. 1999; de Soto 2000; Johnson, McMillan et al. 2000; Acemoglu et al. 2002). Regardless of the specific legal institutions, a central mechanism through which they are shown to promote economic development is by shaping the financing environment of a country. Several cross-country studies, for example, have shown that economies with more developed financing environments tend to both grow more and do so in a more sustained manner (King and Levine 1993a; King and Levine 1993b; Levine 1997).

More specifically, healthy financing environments allow resources to flow into new and growing ventures. The development of new businesses is a central element of economic development because they tend to account for the creation of most new jobs, bring new technologies and innovation into the economy, and spur the process of creative destruction upon which the capitalist system is founded (Schumpeter 1934; Laeven and Woodruff 2004; Schumpeter 2005). Additionally, new and small ventures ensure a better distribution of ability across different occupations, and hence function as an efficient economic sorting mechanism (Banerjee and Newman 1993). Financing environments are especially important to new and growing ventures because small firms are liquidity constrained and as a result are more reliant on external financing (Evans and Jovanovic 1989; Lindh and Ohlsson 1996; Hurst and Lusardi 2004). In fact, financial constraints affect not only aspiring entrepreneurs, but also the small firms that they create. Firms with wider access to external finance tend to invest more, grow more rapidly, and have a higher likelihood of survival (Kaplan and Zingales 1997; 2000; Banerjee and Duflo 2004). To promote healthier financing environments, the argument has been made for institutions such as public financial markets (Black and Gilson 1998); banking regulation that curbs related lending (Johnson, La Porta et al. 2000; La Porta et al. 2003) or guides it (Fohlin 1998; Maurer and Haber Forthcoming), encourages strong monitoring and corporate governance (Johnson, Boone et al. 2000), and promotes local competition to provide a diversified banking structure (Berger and Udell 2002; Berger et al. 2005; Bertrand et al. 2006). While these and other factors have indeed been shown to matter, there is certainly no consensus on which of them are more important or even on their causal direction (Cull et al. 2007).

The lack of consensus is at least partly due to the fact that, with very few exceptions, the literature on institutions and economic development has focused squarely on developed economies that have healthy, well-developed institutional environments. In fact, much of the evidence that links economic growth to financial development depends on the fact that less developed countries (LDCs) have poor institutions and underdeveloped markets. At the same time, it is precisely these LDCs that are more dependent on small firms and entrepreneurship for their stability and growth (Johnson, McMillan et al. 2000; McMillan

and Woodruff 2002; Laeven and Woodruff 2004). Papers that focus on LDCs, their particular institutions, and the resultant behavior of firms tend to only show the suboptimal equilibria and the informal coping behavior that firms engage in to substitute for what are deemed to be the "right" institutions. For example, firms are shown to engage in bribing and corruption to overcome market imperfections (Acemoglu and Verdier 2000; Johnson, Kaufmann et al. 2000); form informal networks and alliances to share information and create political contestation (Razzaz 1994; McMillan and Woodruff 2000); and tap into informal lending mechanisms as well as expensive trade credit to finance their operations (McMillan and Woodruff 1999; Banerjee et al. 2003).

It is much less clear, however, what an LDC with a poor institutional structure is supposed to do to foster the kind of behavior that is required for development. The prescription from the above literature seems to be to reform formal laws and regulations, following a "top-down" approach, to provide the correct incentive alignment and alleviate market imperfections. This view is problematic for two reasons. First, throughout the 1990s a wide array of LDCs followed that approach in compliance with the "Washington Consensus" with disappointing (sometimes disastrous) results (Stiglitz 2001; 2002; Rodrik 2004). The second is that several countries that have ostensibly diverged from that approach have developed at neck breaking pace. As a result, a new prescription is emerging that highlights the complexity of institutional arrangements, the strong coupling between formal and informal norms, and the inertia and resistance to change that they present. Such a prescription puts much emphasis on gradual change, experimentation, and local solutions (Rodrik 2006). It acknowledges that no prescription is useful unless it is strongly grounded in the complexities of institutional change and the mechanisms through which it can be achieved. This, however, presents a challenge. Our current understanding of the mechanisms through which institutions change is limited. More limited still, is our understanding of how institutions can be *purposefully* changed, which is the aim of policy prescriptions.

This dissertation seeks to advance the debate around institutions and economic development in two distinct ways. First, in the present chapter it will summarize our

current understanding of the mechanisms through which institutions operate and, in particular, the mechanisms trough which they change. It will show that the different disciplines concerned with the study of institutions have not properly accounted for human agency and as a result have yielded incomplete –and potentially inaccurate— explanations of institutional change. This omission is particularly problematic for our understanding of purposeful institutional change, which should be the most informative type of change for LDCs that seek to improve their institutions through better policies. Second, in subsequent chapters the dissertation will propose different mechanisms through which individuals initiate institutional change and will provide insights into its processes. It will do so through the presentation of two empirical cases that address the role of individuals in institutional change. The cases touch upon two different aspects of the Mexican financial sector –the creation of the small business credit market in Mexico and the evolution of several microfinance institutions (MFIs)—which are particularly useful to illustrate institutional change in relation to economic development.

Institutional Stability and Change

Most of the academic attention has been placed on the most intriguing aspect of institutions (and indeed what makes them so central): their stability. Scholarship has focused on the discovery of the specific mechanisms through which institutions operate; particularly those that can explain their stability, perpetuation, and reproduction. As I will detail below, important advances have been gained in the discovery of such mechanisms. However, much less attention has been placed on another pervasive and equally central aspect of institutions: their processes of change. While stable by definition, institutions are not exogenous in nature but social constructions endogenous to human action. It must then be the case that, together with stability, change is intrinsically built into them.

In fact, attention has shifted in recent years to the understanding of institutional change, and steady progress has been made in the detection of the mechanisms through which it occurs. In particular, increasing attention has been recently paid to the study of endogenous institutional change. In what follows, I will provide a brief (and admittedly incomplete) summary of the main advances that have been made in this direction. Following the now established convention, I will separate my analysis according to the

three varieties of institutionalism: Rational Choice, Sociological, and Historical.[1] It is important to note that each of these schools has developed an astonishing amount of literature with much internal diversity. Each perspective has clear strengths that advance our understanding of institutions, and weaknesses that render it incomplete. Moreover, the lines that separate them are increasingly unclear and only fully apply for some scholars within each tradition (Hall and Taylor 1996; Thelen 1999). Indeed, some of the most interesting contributions, especially in the analysis of institutional change, have been made by scholars that cross the boundaries and incorporate concepts from different schools (Bates et al. 1998; Streeck and Thelen 2005b). In this chapter, therefore, they are analyzed more as complementary approaches seeking to collectively explain a common phenomenon than as mutually exclusive alternatives.

I focus on the specific mechanisms that each school has developed to understand both how institutions operate and how they change. By mechanisms, I refer to "bits of theory about entities at a different level (e.g. individuals) than the main entities being theorized about (e.g. groups), which serve to make the higher-level theory more supple, more accurate, or more general" (Stinchcome, 1991 in Hedström and Swedberg 1998 : 7). Given that institutions exist at the macro level of society but operate at the micro level by influencing individual behavior, it is easy to see why it is important to understand their mechanisms through a model that straddles different levels of analysis (Vaughan 1998). An understanding of the mechanisms of institutional change, therefore, requires an understanding of the role that individuals play in it; or the way in which individuals interact with institutional structures and are both constrained and empowered by them (Sewell 1992). More specifically, understanding the role of individuals within structures requires understanding what determines their opportunities, their motives, and their choices (McKendall and Wagner III 1997) to show how macro states at one point in time influence the behavior of individual actors, and how these actions generate new macro states at a later time (Coleman 1990; Hedström and Swedberg 1998).

[1] There are several useful treatments of the defining features of the three institutionalisms, especially (Hall and Taylor 1996; Immergut 1998)

Mechanism-based explanations usually invoke causal agents, and in the social sciences the elementary causal agents are individuals. Accordingly, thorough social science explanations should always include explicit references to the causes and consequences of individuals' actions (Coleman 1986). I argue that, while each institutionalism has established important mechanisms that help explain institutional change, the role that individuals play in that process is yet unclear. As I will point out, this omission has rendered not only incomplete, but also potentially wrong accounts of institutional change. In most of the existing literature, institutional change is apparently left to chance, luck, or accident, and there is no room for purposive effort to transform existing institutions. This is problematic on several levels. From a theory perspective, given that social processes operate through mechanisms at the individual level, institutional change must also be driven by individuals (DiMaggio 1988). In order to fully understand any process of change, therefore, we need a systematic understanding of the origins, actions, and types of the individuals that drive it. From a practical perspective, given that institutions play such a central role in structuring, limiting, empowering, and in some cases determining human action it is important to fully understand the process through which they change and, more specifically, the process through which they are purposefully changed.

Rational Choice Institutionalism

Mechanisms of Stability

The Rational Choice School of institutionalism developed out of the economics tradition as it struggled to explain problems of collective action (Olson 1965; Riker 1980; Immergut 1998). Given its origins, this school has greatly relied on deductive tools, such as game theory, and has developed an explanation of institutions centered on the maintenance of self-reinforcing equilibria that endogenously generate behavioral patterns (Weingast 2002). Characteristically, institutions are explained in strictly functional terms, through the value they add to society by lowering transaction and coordination costs, as well as providing solutions to problems of collective action, such as Arrow's impossibility theorem (Riker 1980; North 1990). In this view of institutions, actors are assumed to have a fixed, known set of preferences, and each individual is assumed to instrumentally seek to maximize them through extensive calculation and strategic action

(Weingast and Marshall 1988; Hall and Taylor 1996). Moreover, institutions are viewed as voluntary agreements between actors that seek to resolve a common problem.

The fact that institutions derive from efficient calculation does not imply that they are efficient themselves. In fact, one of the most valuable contributions of Rational Choice Institutionalism has been the intuition behind the existence of sub-optimal equilibria through self-enforcing mechanisms (North 1990). Institutions are viewed as the structure –or rules—of a game in which strategic actors are participating. Once a particular equilibrium is reached, there are several mechanisms that make it self-enforcing.[2] Most of these mechanisms operate at the level of individuals' beliefs: given that institutions provide a fixed set of rules and give all actors the same information, individuals set their expectations accordingly and thus generate stability (Dixit 2003). Eventually, given that individuals are given the same information and rules, they also come to share common beliefs. As the game is played out in time, and the equilibrium that is reached is constantly reinforced, only shared beliefs come to exist (Greif 1993; 1994; Dixit 2004). In fact, even if actors are not given full information, they will engage in probabilistic calculation of others' beliefs and, through Bayesian updating, they will still come to a single set of shared beliefs (Greif and Laitin 2004).

More specifically, there are several mechanisms that maintain a reached equilibrium. First, arriving at an equilibrium point is assumed to have large initial costs, and thus moving out of that equilibrium into a new one will entail significant switching costs. Actors will only be willing to move once the benefits of change outweigh the costs. Second, actors are assumed to learn, so in the repetition of their activities in a particular equilibrium they are bound to become increasingly efficient at them and reap more benefits from the status quo. Moving into a new equilibrium would imply losing that added efficiency. Third, because institutions seek to solve problems of collective action, there are large coordination effects (similar to network effects), where an actor's benefit from sticking to a norm increases as other actors conform as well. Fourth, there are

[2] Similar to the thrust of this paper, Rational Choice theorists have constantly sought to disentangle the micro-level mechanisms that drive human behavior. Most of their mechanisms are assumed to operate at the individual level.

adaptive expectations, where actors come to expect others to behave according to a norm, and they therefore strategically seek to maximize their gain given that expectation. Others also adapt their expectations accordingly, making it more economical to conform. Because all actors know that others are thinking in similar terms, the norm is continuously enforced (Pierson 2000b; a; Greif and Laitin 2004).[3]

Mechanisms of Change

Rational Choice Institutionalism focuses on self-enforcing equilibria, where different individuals face a fixed set of exogenously-determined parameters and reach equilibrium by maximizing a set of endogenously-determined variables. As a result, change has been particularly difficult to explain within its frameworks. Exogenous parameters are assumed to be fixed (otherwise, the game would not be "playable"), and endogenous variables are also fixed, either because individual preferences are stable, or because beliefs come to be shared as described above. Because of these limitations, change could only be caused by an exogenous shock that shifted the parameters of the game, thus destabilizing the existing equilibrium and prompting actors to find a new one. Because only exogenous parameters are changed while endogenous preferences and beliefs remain stable, change is largely "path dependent" and new equilibria are likely to be found relatively close to previous solutions (North 1990). Change is therefore achieved through "institutional refinement" where, once exogenous parameters are changed, actors come to realize that the benefits of change outweigh its costs and gradually move to a new, stable equilibrium. It also follows a pattern of "punctuated equilibrium" as it moves from one stable point to the next, and long periods of stability are temporarily interrupted by (relatively large and rare) exogenous shocks.

Institutional change, however, does not always follow a pattern of punctuated equilibria destabilized by major shocks. Even when it does, some of those shocks are actually endogenous to the system. Change often happens through gradual, endogenous changes that may start a new path and end up fully transforming institutions (Streeck and Thelen 2005a). To deal with this, more recent work has developed models where path

[3] Pierson's mechanisms of stability were actually developed within Historical Institutionalism. However, they have been incorporated into Rational Choice and operate through similar assumptions.

dependence is seriously considered (Pierson 2000b; a) and small but reinforcing mechanisms can eventually tip the balance of a game to generate significant institutional change (Greif and Laitin 2004). In this view, on top of the traditional parameters and variables of Rational Choice Institutionalism, a set of "quasi-parameters" are included. These quasi-parameters are not central to the rules of the game, but are endogenously – and gradually—affected by it and as a result are not stable in time. Since they do not form a part of the constitutive parameters, they don't affect the rules of the game or any of its variables as they change, and they therefore don't affect the self-enforcing nature of institutions (Bowles 1998). Gradual changes in quasi-parameters, however, do marginally affect the payoffs to actors and may either increase or decrease the self-enforcing nature of an institution, turning it into a self-reinforcing or self-undermining equilibrium (Greif and Laitin 2004). Initially, actors may not notice changes in quasi-parameters, or may not see them as significant, but as changes become more visible some actors may realize that their actions are no longer self-reinforcing in the institution. At that point, certain actors may have the incentive to risk by deviating from the equilibrium strategy and experiment new options. As some deviating actors achieve superior results, others that observe them will adjust their beliefs accordingly and a new stable equilibrium is reached (Bowles 1998; Vogel 2005). In late medieval times, for example, both Venice and Genoa created stable and successful political regimes through agreements among the strongest clans in each city. Genoa's clans, however, initially joined forces to fight against an *external* threat of invasion. As they gained economic power and the external threat diminished, however, increased wealth –achieved through the institutional equilibrium—gave each clan the ability to sustain an army and the cooperative equilibrium became self-undermining as clans engaged in a prolonged civil war. In contrast, Venice's clans joined forces around an institution centered in the belief that each clan would join together to fight against a renegade *–internal—*clan that sought to achieve dominance of the city. As a result, no clan had the incentive to increase in military strength, as others would band together against it and the equilibrium was self-reinforcing (Greif and Laitin 2004).

While these newer accounts are much better equipped to deal with institutional change and they have provided us with great intuition and tools, they create several questions.

First, there is an endogenous relationship between the rules of the game and actors' beliefs, where the solution of the game is strongly shaped by beliefs, but it also then reinforces (and in fact changes) them to become self-enforcing. This cycling of preferences and institutions must generate an important level of bias towards certain beliefs (Dixit 2004), but it is not clear where the bias may initially come from (Immergut 1998). Second, if institutional equilibrium implies that "only shared beliefs will exist" (Greif 1993; 1994), then how can new ideas emerge? Given that all actors within an institutionalized setting share the same beliefs, how can any of them envision the possibility of an alternative? Third, and related, in the view of endogenous institutional change it is assumed that certain actors with new knowledge will be the first to realize the self-undermining nature of institutions (Bowles 1998), and thus will be the first to experiment; but where does this new knowledge come from? Fourth, experimentation is assumed to be caused by the fact that ex-ante expectations of innovative actors may prove to fail, and thus other actors will learn ex-post from the experience and correspondingly adjust their beliefs; but how do different actors develop differing beliefs about their ex-ante expectations and thus have differing incentives to experiment? Finally, taking the idea of path dependence seriously, where relatively minor events in time may have large future consequences due to self-reinforcing mechanisms (Mahoney 2000), then the question of who possesses what knowledge to initially deviate from the norm may prove definitive in determining the new path that the institution will take (Greif and Laitin 2004).

Sociological Institutionalism

Mechanisms of Stability

This school developed from organization theory and its explanation of the remarkable similarity and stability of existing (often highly inefficient) organizational forms (Meyer and Rowan 1977). Sociological Institutionalism views institutions as a stable set of norms, rules, and procedures but also as existing symbol systems, cognitive scripts, and moral templates that together provide the frames of meaning indispensable for individuals to interpret the world (Campbell 1998). Institutions are thus myths and ceremonies that are created in the transmission process of culturally-specific practices (Hall and Taylor 1996). Individuals are socialized into specific roles with prescriptive

norms of behavior. In that process, institutions not only shape individuals' calculations, but they shape their actual preferences and identities, and thus determine what individuals can even conceive as legitimate courses of action (Berger and Luckmann 1966).

While Sociological Institutionalism scholars are skeptical –to say the least—of functionalist explanations of institutions, they still view them as performing an important role. The main difference with rational institutionalism lies in the mechanism through which they operate and are perpetuated. While for Rational Choice Institutionalism stability comes from utilitarian value, for Sociological Institutionalism stability comes from legitimacy. Contrary to a Rational Choice view of actors, here individuals experience high levels of uncertainty[4] and ambiguity in their interpretation of the world. Through gradual processes of interaction, legitimate courses of action are created and constantly reproduced (Giddens 1984). Meaning is therefore neither universally given nor deducted from calculation, but gradually constructed through face-to-face interaction (Goffman 1959; 1983). Institutions constrain behavior through different layers. Individuals and organizations meet specific institutions such as rules, norms, and procedures; as well as larger, general institutions such as cognitive scripts and moral templates (Haveman 1993; Dobbin and Dowd 1997; Ingram and Rao 2004).

A central aspect of this view of institutions, then, is the amount of uncertainty and ambiguity that actors face. It is not only that actors don't know with certainty that a particular outcome will occur and resort to probability (defined as risk). Rather, they don't even know the probability distribution of outcomes –or the possible array of outcomes, for that matter (Knight 1921; Beckert 1999; 2003). Due to this high level of uncertainty, individuals constantly look for clues and shortcuts that will allow them to make decisions, and most of those are found in the social structure that surrounds them (DiMaggio and Powell 1983). What is seen as legitimate by individuals is therefore extremely contingent, and depends on complex layers of interactions between actors and institutions (Berger and Luckmann 1966). Institutional practices are thus gradually created and diffused through different types of isomorphism as actors constantly scan

[4] Here uncertainty is more encompassing than risk: see below.

their environment to copy practices they deem successful or legitimate (Meyer and Rowan 1977; DiMaggio and Powell 1983; Haveman 1992; 1993). Institutional stability is maintained by limiting the options that actors deem as legitimate, and interaction between these actors constantly reinforces their shared understanding of what is allowed, thus perpetuating it (Douglas 1986). An equally important consequence of uncertainty, and the use of legitimacy as a shortcut around it, is the emergence of status as a source of legitimacy. That is, given the uncertainty in social outcomes –and more importantly, in what actors should consider a "good" outcome—minor differences in outcome qualities during initial interactions between actors get assigned large differences in status, which are then reproduced and expanded through time (Podolny 1993). Because of uncertainty, and the need to simplify social interactions, high-status actors are then awarded much more deference, as well as better access to resources and opportunities, thus increasing their centrality in the social structure (Podolny 1993; Benjamin and Podolny 1999; Zuckerman 1999). Status and legitimacy, in consequence, are central mechanisms in the institutionalization of practices, structures, and the stability of social outcomes.

Another important, and related, contribution of Sociological Institutionalism is the notion that institutions –and the social structure—not only constrain but also empower actors. While it is true that social institutions limit the options that individuals deem as possible or legitimate, the inherent ambiguity and complexity of social life also empowers actors with different sets of resources and opportunities to interpret their environment and act in consequence (Swidler 1986; Sewell 1992; Swidler 2001). This feature of institutions also promotes stability through self-reinforcing mechanisms such as the 'Matthew effect' where social structure is reproduced by the increasing status of certain actors and the differentiated opportunities that they are awarded (Merton 1968; Podolny 1993; Benjamin and Podolny 1999).

Mechanisms of Change

Similar to Rational Choice Institutionalism, initial explanations of institutional change relied heavily on exogenous shocks or changes –in a law, for example—that increased ambiguity and generated opportunities for actors to engage in "local rationality". Through a process of Giddens-type structuration and isomorphic diffusion, certain practices

become legitimized and institutionalized (Giddens 1984; Barley 1986; Haveman 1992; Barley and Tolbert 1997; Haveman and Rao 1997; Hargadon and Douglas 2001; Ingram and Rao 2004). These exogenous changes in specific institutions not only affect general institutions such as norms and scripts, but also as practices feed down through the social structure and then back up, they endogenously end up transforming other institutions – including the specific institutions whose shock initiated the change (Edelman 1990; 1992; Clemens 1993; Edelman et al. 1999). When an exogenous shock to an institution happens, individuals affected by that institution encounter an increased degree of uncertainty which prompts them to (strategically and reactively) import cognitive scripts that have been legitimized in other social instances and recombine them in creative ways to introduce them into their new situation. Cognitive scripts are imported and recombined through processes of border crossing and "bricolage" (Parkhurst Ferguson 1998; Rao et al. 2003; 2005). This usage of previously legitimated scripts allows actors to marginally experiment without encountering absolute resistance. As some of these recombinations generate successful results, other actors imitate them and in that process of imitation begin to legitimize the new practice. These mimetic practices can quickly become diffused and feed "back up" the structure, until they are perceived as the legitimate course of action. The creation of equal employment opportunity laws, for example, generated great ambiguity in organizations around compliance issues. Certain organizations created the "rational myth" of grievance procedures to externally show their commitment to the laws. Such practices, however, quickly diffused among organizations and eventually affected legal considerations by courts, thus inducing the judiciary to incorporate grievance procedures into legal constructions of compliance with the law (Edelman et al. 1999).

Successful experimentation, of course, is not available to all. Given the uncertainties that surround social life, actors risk punishment when diverging from their accepted role performance (Zuckerman 1999). While it is true that all actors can attempt to experiment –and in fact there may be important gains to be made through innovation—only experimentation by actors that are seen as relatively legitimate will be taken seriously and imitated if successful (Haveman 1993). In addition, only actors who have either

established their legitimacy through high status, or who have such low status that are not considered relevant will be allowed to experiment without punishment (Phillips and Zuckerman 2001). At the same time, actors that are too visible or too central in the structure may find it harder to experiment as divergences from their role performance could face immediate contestation (Clemens 1993; 1997a). Moreover, such experimentation and recombination of scripts requires exceptional social skill and favorable structural positions (Padgett and Ansell 1993; Fligstein 1997; 2001). In institutional experimentation, therefore, actors walk a very fine line that, if crossed, could have dire consequences.

A key contribution of this last strand of literature is the insight that institutions and the organizations that they cover must, by definition, be synchronized in a process of mutual legitimation. This means that organizations and institutions co-evolve, where an institutional change must imply a change in organizational forms, and vice versa (Clemens 1993; 1997a; Haveman and Rao 1997; Clemens and Cook 1999; Edelman et al. 1999). In this process, there is an implicit, if not well evidenced, role for agency.

> "Institutional entrepreneurs skillfully align organizational form and the institution it embodies with the master rules of society(...) The result of that is filtered through the interaction between the designers of organizational form and the institutions they incarnate" (Haveman and Rao 1997 : 1613).

Insightful as these accounts are, they also raise some questions. First, it has been shown that only actors placed in a particular position of the social structure can successfully engage in experimentation to generate institutional change (Padgett and Ansell 1993; Padgett 2001). However, it must be the fact that other actors, placed in similar positions, also had access to similar resources and opportunities. Regrettably, we don't usually observe those other actors and the strategies they pursued that failed. That is, sociological accounts suffer from "survivorship bias" and as a result tend to be devoid of politics and contestation, or contestation is shown to follow predictable paths. Chain stores in the United States, for example, became legitimized against strong opposition from independent stores. Chain stores prevailed because they were able to organize centrally and ally with unions; while independents only had localized grassroots movements in

their favor (Ingram and Rao 2004). The fact that we only observe the result of a particular path of change does not allow us to understand whether other paths were attempted, and the process of contestation that led to choose one path over another. What is missing, then, is a useful counterfactual (Fearon 1991; George and Bennett 2005). Second, we know that social networks sometimes diffuse institutional innovations, but they also sometimes provide the means and resources to induce institutional change. Which networks allow for which processes better and when? And what determines whether a specific network position will be activated for different purposes? (Clemens and Cook 1999; Reagans and Zuckerman 2007). Third, we know by definition that the conditions for institutional change are quite rare, and very specific combinations of skilled actors and structural positions will allow for the mechanisms of change to be activated (Padgett and Ansell 1993; Fligstein 1997; Beckert 1999), but it is also the case that "not every actor confronts the conditions of institutional multiplicity or possesses the skill and resources to exploit them" (Clemens and Cook 1999). It would be useful, then, to have a better understanding of which types of actor-structure combinations and interactions are more likely to result in successful initiations of institutional change, and what political contestation occurs in that process.

Historical Institutionalism

Mechanisms of Stability

Historical Institutionalism developed from Weber's work and the tradition of macro-sociological analysis. It views the representation of interests as being shaped by collective actors and institutions, each of which bears traces of its own history (Immergut 1998). More importantly, the role of institutions is to structure politics. Human behavior is seen as driven entirely by power relations and the pursuit of political interests in a world of mutual contestation (Steinmo et al. 1992). Institutions are more narrowly defined, as they encompass only the formal, socially sanctioned, and collectively enforced rules and norms. These typically involve mutually related rights and obligations for actors that clearly distinguish between appropriate and inappropriate behaviors (Streeck and Thelen 2005b) as well as, to a lesser extent, culturally acceptable lines of action (Katzenstein 1977; Katzenstein et al. 1998). Given the highly contentious nature of human action, it is only by looking at the particular constellation of variables at specific

points in time that we can truly understand later outcomes. Causality is thus highly contextual, as it depends on specific interactions between institutional structures and historical junctures. Institutions in Historical Institutionalism are viewed as filters that favor certain interpretations of goals and interests over others, and these interpretations are developed through complex historical processes (Hall and Taylor 1996; Immergut 1998; Thelen 1999). Actors are in perpetual contestation over resources and constantly interact with existing structures seeking to increase their power. This entails strategic behavior that is acutely aware of contending groups, their interpretations, and their actions.

Historical Institutionalism has provided invaluable contributions to our understanding of institutions. First, it brings in the importance of contestation between groups as a central aspect of human behavior. Second, in that perpetual contestation it also incorporates the importance of power asymmetries between groups in shaping institutional outcomes. Certain groups have much more opportunity to shape their environment than others, and this asymmetry is determined by historical processes of contestation. More importantly, in Historical Institutionalism, the "losers" do not disappear or necessarily align their beliefs and interests with the rest; rather, they remain in the background lurking for an opportunity to resurge (Thelen 1999). Third, it allows us to better comprehend the inevitable, unintended consequences of institutions; where an institution that was "designed" to govern a specific process is likely to alter the balance of power between actors that are also contending for other resources (Gourevitch 1986). Fourth, Historical Institutionalism has provided deep insights into the path dependent nature of events: because of the high contingency of human action, small and apparently unimportant actions can have large, unanticipated and long-lasting consequences (Mahoney 2000; Pierson 2000b; a). Fifth, because of path dependence, institutions are deeply embedded in temporal and historical processes, and Historical Institutionalism has provided us with the insight and the tools to better understand them (Steinmo et al. 1992). Sixth, as a result of path dependence and the pervasiveness of unintended consequences, institutions exist in an array of multi-layered institutional orders, and are likely to mostly complement each other but also provide ample room for contestation, ambiguity, and outright contradiction

between them (Streeck and Thelen 2005b). The combination of all these processes and mechanisms lead to systems where the tight balance of power and path-dependent nature of events generate remarkable stability and resistance to change.

Mechanisms of Change

Historical Institutionalism holds a (not surprisingly) contentious relationship to change, greatly summarized in Peter Gourevitch's observation that "among comparativists, happiness is a crisis that hits a lot of countries –for in moments of crisis, the elements that previously held a system together come into full relief" (Gourevitch 1986 , quoted in Thelen (1999)). Because of their highly contingent view of events, comparativists have relied on extreme exogenous shocks to show that, even in moments of wide social change, certain patterns of interaction remain remarkably stable. Institutional change is therefore precipitated by critical junctures that create opportunities by temporarily shifting the balance of power within a system. Groups in contention will then quickly move to advance their interests and in so doing will change the existing structure. Because of this dependence on extreme exogenous shocks, it is a model of institutional change through punctuated equilibrium, where the specific temporal and historical factors, as they interact with the existing power structure, determine the end point (Hall and Taylor 1996). Opportunities for institutional change are created through the interaction between different coexisting institutional orders. When different orders collide, opportunities for political change are created (Dunlavy 1992). Existing gaps between institutional orders, together with lags between short and long term institutional processes create opportunities for non-state actors to influence polity in unanticipated ways. In the German financial system, for example, the key financial institutions that developed through consensual bargaining by the three major banking groups depended on a tight coupling between large banks and large domestic firms, shielded from external influence. As domestic firms reduced their borrowing, domestic banks became increasingly dependent on foreign institutional investors and, through their international activities weakened the very institutional order they had helped create. In so doing, they put the German financial system on an entirely –yet uncertain—new path (Deeg 2005). Through complex feedback mechanisms (as described in the rational-choice section

above), small actions by contending groups can launch events in an entirely new path, leading to large institutional transformations (Pierson 2000b; a; 2001).

More recent work has focused on processes of endogenous and incremental –yet significant—change. The challenge for Historical Institutionalism has been to show how stable norms and balances of power can shift without an exogenous change that temporarily distorts them. They propose that, given that institutions coexist in different orders and layers, there are inherent and ubiquitous conflicts over interpretations and norms. In the daily (problematic) enactment of rules, actors create increasingly large gaps between existing rules and their actual enactment. These gaps may be created strategically or through "honest disagreement" on interpretations of rules. As gaps increase, certain political entrepreneurs can rush in to fill the void seeking to increase their power and, through mechanisms of self-reinforcing path dependence, greatly transform an institution (Streeck and Thelen 2005a). More specifically, Streeck and Thelen propose five distinct mechanisms through which institutions can be endogenously changed. Displacement occurs when, given that institutions can't possibly sanction all types of behavior and often show internal contradictions, traditional configurations are vulnerable to change as new behavioral logics emerge through the rediscovery or activation –and the political cultivation—of alternative institutional forms. Often these shifts are initiated in specific critical junctures where latent subsidiary ways of action are rediscovered and emerge. Layering happens when minor, marginal, and apparently complementary innovations are made to existing institutions by adding additional characteristics or layers. These new layers, however, through self-reinforcing mechanisms gradually empower an unintended group, and thus sow the seeds of radical institutional transformation. Drift occurs because institutions, according to Streeck and Thelen, require active maintenance and need to be constantly reset and refocused. In some cases, political actors may realize that a set of "nondecisions" may lead an existing institution to gradually shift and lose its centrality and power, and thus generate new political opportunities. Conversion occurs when existing institutions are employed to deal with new, unanticipated problems (similar to the Sociological Institutionalism's bricolage, described above). As existing institutional resources are used in

unconventional ways, however, they are transformed in unexptected and unintended ways both by central and by marginal actors. This can only happen in specific, critical junctures and the timing and direction of these conversions are determinant of future outcomes. Last, exhaustion occurs when inherent contradictions within an institution generate a mechanism of self-undermining that ultimately leads to its breakdown (Streeck and Thelen 2005b).

Similar Rational Choice and Sociological Institutionalisms, Historical Institutionalism has generated deep, important insights into the processes of institutional permanence and change. It has also generated its own questions. First, even though the model of political contestation is highly dependent on actors that compete for resources, it is very hard to place actors within it. Comparativists need proof of individuals' views and preferences at the specific time of their actions, and it is very hard to say, in retrospect, whether observed preferences were the cause or the result of processes of institutional change. Actors are therefore mostly assumed, but rarely truly accounted for. Second, if certain small exercises of rule-bending and creative interpretation are likely to lead to large transformations, it is of extreme importance to understand exactly how that rule-bending occurs and who engages in it. If change can come from simple exercises in rule-bending, we need to understand why institutions are not constantly in flux as all agents try to engage in constant, creative, transformative interpretations of rules. It is important to understand which agents are able to engage in rule bending, when they are able to do it, and which specific types of rule bending are more likely to generate successful outcomes. Third, if institutions provide filters that determine what is 'right' and what is 'wrong', then it is not enough to say that inherent contradictions will lead to gaps between rules and enactment. Given the highly contextual nature of changes, we would need to understand where differing interpretations of rules come from, and which actors are exposed to different interpretations and how. We would also need to understand how actors pick between different choices of interpretation and why. We need, in summary, a better understanding of the interaction between an actor's power and her cognitive resources (Thelen 1999). Fourth, if we take the idea of path dependence seriously, then it must be the case that *who* engages in political entrepreneurship and institutional change

efforts and *when* she engages in it are likely to be determinant in the outcome. Therefore, we need a better understanding of which power positions are more likely to allow for creative interpretation and enactment of institutions, and which historical junctures are more likely to present such opportunities.

Agency and Institutional Change

With this exercise, I do not intend to suggest that the mechanisms that the three institutionalisms have provided for understanding institutional dynamics are wrong. In fact, quite the opposite is true. What I do intend to say is that the three conceptions of institutions could be complemented by a better understanding of the mechanisms through which individuals initiate processes of institutional change. The three institutionalisms have analyzed mechanisms that explain institutional operation and change at different levels, but by not addressing the issue of agency directly, they have missed a core set of mechanisms that help explain how institutions emerge and evolve.

At issue is the fact that different disciplines have converged on the notion that institutions operate through the convergence of beliefs (even if they sometimes disagree on how those beliefs become stable in the first place). An actor expects others to follow specific behaviors and interpret her own actions in a particular way so she behaves accordingly (Schelling 1960). Because others anticipated precisely this mental calculation, they react in fulfillment of the actor's expectations and the system is thus reinforced and perpetuated (Greif 1993; Greif et al. 1994). As different actors' beliefs are reinforced, they also become narrower and more stable to the point where only similar beliefs remain (Bowles 1998). This is further reinforced as organizations adapt to existing norms (Haveman and Rao 1997) and certain groups gain power as they differentially benefit from them (Immergut 1992). At their mature state, institutions are said to narrow what is even considered feasible or thinkable (Campbell 1998). Institutional stability then hinges on uncertainty, the costs of achieving a set of collective beliefs that reduces it, and the reinforcing nature of stable expectations that create increasingly strong incentives to adapt (Dunlavy 1992; Mahoney 2000; Pierson 2000a).

It follows that, if institutional stability arises from and in turn reinforces a stable set of collective beliefs, then institutional change must also entail changing expectations (Greif and Laitin 2004), and this change in expectations must be experienced and brought into a system by individuals. As I argued above, however, none of the institutionalisms can successfully explain *how* this process works, or *who* can carry it through. That is, if institutions operate through the convergence of beliefs, then how can a divergent belief even emerge? Put differently, how can an individual who has been socialized into a particular institutional context and is presumably deeply embedded in a community of meaning (Piore 1995) abstract herself from it to envision a different alternative? (Battilana 2006).

Consider, however, that certain individuals have not *always* belonged to a particular system or –at the very least—have interacted with other systems much more than their peers. Given that knowledge is acquired through socialization, moving away from a core group can in fact generate abstract knowledge, which can then highlight the existence of institutional alternatives for certain individuals (Piaget 1965; Berger and Luckmann 1966; Piore 1995). A combination of mixed backgrounds and border-crossing may thus grant certain actors access to completely different sources of information, which they can leverage in new environments where such information is not readily available (Simmel 1950; Reagans and Zuckerman Forthcoming). It may also provide a broader set of cultural "tools" which they can strategically draw upon (Swidler 1986; 2001). In cases where existing institutions have ignored or underestimated certain opportunities, these individuals may perceive them while others simply don't have the tools to detect them. As a result, cosmopolitan actors with divergent beliefs may be present within any institutionalized system. But then how can we reconcile this with the notion that institutions operate through convergence in beliefs? If there are individuals with divergent beliefs present, why would the institutional equilibrium persist?

The apparent paradox is solved by the fact that institutions operate through convergence in *public* beliefs, and not necessarily in the privately-held beliefs of all individuals (Kuran 1989; Centola et al. 2005). In other words, institutional stability may emerge from the

convergence of second order beliefs (what an actor thinks specific others in that context will think) or even third order beliefs (what an actor thinks "most people" would think); while first order (or internal) beliefs may be different (Ridgeway and Correll 2006). This means that institutional change would not require the abstract creation of new beliefs, but the emergence of some already existing yet private beliefs that invalidate the existing institution. But if this is the case, why are institutions constantly associated with unquestioning "taken-for-grantedness"? Why is it that, in institutionalized systems, only beliefs that seem to reinforce the status quo are observed?

There are at least two settings that help explain this. First, consider a system where institutions are so strong that first public, but then also private beliefs have converged through self-reinforcing dynamics (Pierson 2000a). Such a system would involve actors that simply cannot imagine an alternative way of operating and would therefore completely depend on an external source of information to challenge existing beliefs. For example, in settings where there are high levels of uncertainty –such as financial markets— it is easy for a relatively uninformed majority who don't know what the "right" belief is to follow the lead of a strong-willed minority of "experts" (Banerjee 1992). In such a setting, institutions could indeed reach a mature state where they are no longer questioned and are completely taken for granted. Second, consider a more likely institutional system where public beliefs have converged but there is nonetheless significant divergence in private beliefs (Kuran 1997; Centola *et al.* 2005). In this instance, many actors may believe that the "way things are done" is not the most efficient, and can probably even imagine alternative ways of operating. The same actors, however, would keep their views private due to pluralistic ignorance and the fear of punishment for deviant behavior (O'Gorman 1975).

At any point in time within an institution, then, there are potentially three separate types of actors. The first is the core group, composed of the "experts" and "hard core" believers in the status quo. They would be the group that simply can't conceive of an alternative and are deeply invested in the existing solution. A second group would be composed of people who may understand that there are (theoretically) potential alternatives, but don't

know enough about the phenomenon to truly understand the implications of following a different approach. Given that the existing institutional configuration "works", they don't see the need to invest much in learning more or in thinking about true alternatives. The third group would be the innovators, people who know enough about the phenomenon to understand the alternatives and their potential benefits. In their case, they truly believe that a different solution would be better. Notice how, at any point in time, we would only observe convergence of *all* beliefs. Notice also that, for the first two groups, the existing configuration would indeed be taken for granted and would indeed not be questioned. As for the third group, diverging first order beliefs would be kept private to avoid potential costs, and actors would in fact publicly express their agreement with the institution (Kuran 1997; Centola et al. 2005).

Also note that, in both of the cases defined above, should new information that invalidates the public belief –or at least resolves the constraint of pluralistic ignorance—become public within the system, then drastic changes may occur quite rapidly (Kuran 1989; Banerjee 1992). Exogenous shocks can have precisely that effect, either altering existing conditions or suddenly bringing new information into public light. Aside from external shocks, actors may also bring in new information by experimenting with alternative courses of action, which may generate unanticipated but desirable results (Bowles 1998; Greif and Laitin 2004). Uncertainty, however, makes it extremely difficult for actors to diverge from institutionalized practices, as they know that others are expecting them to behave in a certain way and, should they diverge from it, it is unclear what results –and more importantly what costs—such a divergence would entail (Schelling 1960). This is precisely why experimentation, and especially institutional experimentation, is both extremely important and extremely hard to do. In order to precipitate change, it is necessary to question reigning beliefs by *showing* that alternatives are possible, as actors who are vested in the existing solution –and, as mentioned above, have taken it for granted—could otherwise not conceptualize the potential benefits of change. At the same time, and given the uncertainty in outcomes and the potentially high costs involved, why would an actor ever engage in this? Put differently, under what conditions would actors, who have chosen to keep diverging

beliefs private due to the potential costs of deviance, decide to act upon those beliefs and take the risk of experimentation? What shift in conditions could change their cost-benefit balance enough to induce action?

One shift, suggested in different forms by several disciplines and mentioned above, would result from a process of gradual 'institutional divergence'[5] where, because institutions can't possibly sanction all types of behavior or anticipate the consequences of all existing norms (Merton 1936; Gourevitch 1986; Palier 2005), they may inadvertently affect external factors or generate small internal contradictions which, over time, may grow and affect the expected benefits from divergence (Bowles 1998; Greif and Laitin 2004; Vogel 2005). Certain actors will notice these opportunities and, once the potential benefits become attractive enough, will begin to experiment with new behaviors. If they are successful, they will be imitated by others and in the process will inadvertently promote alternative institutional forms. A second (possibly complementary) option is that actors may *purposefully* try to change existing configurations through 'institutionalization projects' (DiMaggio 1988; Colomy 1998). In this case, an actor will not only try to bend norms to pursue an opportunity but will actually seek to change the norms through institutional additions.[6] In Germany, for example, initial training programs were developed with the artisanal sector in mind. As industrial actors developed their own programs and sought to legitimate them, they copied some of the artisanal sector's features but not all were applicable or desirable. The interaction between these two parallel types of training programs altered the entire trajectory of labor institutions in Germany (Thelen 2004). More drastically, existing "losers" of the institutional configuration may actively set out to strategically change it to alter the balance of power with unpredictable systemic consequences (Clemens 1993; 1999; Thelen 1999; Streeck and Thelen 2005b). An example of this is the process of "oblique institutional attack" followed by labor, agrarian, and women's groups in the nineteenth and early twentieth-

[5] Note that I am using a different concept from Streeck and Thelen's *'institutional drift'*. In their case, drift only refers to cases where political actors purposefully decide, through "non-decisions", to not engage in institutional maintenance, which leads to a gradual shift. Here, I also include gradual but increasing divergence between environmental conditions and institutionalized norms that provides room for experimentation, or what Streeck and Thelen would define as 'displacement'.
[6] This is what Streeck and Thelen define as 'layering'.

century United States which resulted in the creation of interest group politics in the country (Clemens 1997b).

This solves part of the problem by showing that growing institutional "gaps" increase the potential benefits for actors who experiment, thus changing one side of the cost-benefit balance of divergence. It does not, however, help us understand how actors manage the costs of such experimentation. That is, actors with different positions in the social structure are bound to have differing costs –especially *relative* costs—to experimentation. These costs would be manifest both in the difficulty or barriers to initiate an experiment and in the potential consequences of deviant behavior. The first manifestation of them would be the issue of pluralistic ignorance, which would make even the calculation of potential costs impossible. The costs should thus affect who can first engage in experimentation and who is likely to succeed. This is important because, due to path dependence, small actions –especially when they are driven by latent opportunities—can lead to long-lasting outcomes (Mahoney 2000; Pierson 2000a; b). This means that the identity of the actor (or group of actors) that first diverges from existing norms successfully may have a lasting impact on the institutional configurations that ensue. In times of Lyndon Johnson, for example, the political structure of the United States was ripe for political brokers to exploit the potential of disenfranchised yet wealthy actors. It is easy to imagine that, had Lyndon Johnson not succeeded at his efforts, somebody else would have taken his place. At the same time, the fact that it was Lyndon Johnson (or put differently, somebody in his particular position) and not somebody else had profound implications for the American political system that would have been impossible to foresee when he was just a young senator (Caro 1982; 1990).

It follows that, to understand the emergence of a new institution, it is not enough to understand that *somebody* will bring new information to an institutional system through experimentation; it is also important to know *who* that individual is likely to be (Clemens and Cook 1999). Even though we anticipate an individual who spans diverse communities of meaning to be the one that detects latent opportunities, social systems are bound to have several of these 'cosmopolitan' actors (Simmel 1950; Rogers and

Bhowmik 1970/1971) so we would like to have a systematic understanding of which of them are more likely to act upon those opportunities, and which of them are more likely to succeed. Put differently, we would want a better understanding of who we can expect to become a successful institutional entrepreneur.

Who Can Initiate Institutional Change?

Once an opportunity is recognized, (purposeful) institutional change is "expensive and requires high levels of both interest and resources" and is achieved when *organized actors* amass the resources to accomplish it through institutionalization projects (DiMaggio 1988 :14). This sentence helps clarify the types of individuals we could expect to successfully act as institutional entrepreneurs. First, institutional change is *expensive*. As I explained above, endogenous institutional change involves experimenting with new behaviors to challenge existing collective beliefs. Institutions, however, do not operate in the void, so institutional change usually entails organizational change as well (Haveman and Rao 1997). This means that experiments will often be carried out within organizations, which requires access to significant amounts of resources (Burgelman 1983 a,b). One way to challenge the belief that small businesses are too risky to lend to, for example, would be to actually choose a group of typical small businesses, grant them a loan, and collect the loans successfully. This would require –at a minimum—money to grant the loans, as well as a group of people to find prospective firms and perform some sort of credit analysis. To be successful, an institutional entrepreneur would therefore need to know where organizational resources lie and have access to them; and such knowledge and access is not available to all members equally (Burgelman 1994).

Second, institutional change requires a large interest, or motivation, to engender it. I previously discussed how change may be sparked not only by a planned initiative but also by unanticipated consequences of marginal "additions" or adjustments (Vogel 2005). Regardless, the initiation of change entails certain deviation from norms, which in turn entails significant risks. But who would have the motivation to deviate? And who would have the ability to do it? In other words, who would be both willing *and* able to bend or break existing norms? On the first question, the study of deviance has long asserted that not all members of a social group will have the same inclination to deviate. More

specifically, individuals who accept culturally defined goals but have less access to institutionalized means of attaining them are prone to feel increasing strain and develop a motivation to deviate (Clinard 1964; Merton 1968). Institutional entrepreneurship, as differentiated from crime, is a special –but much less studied and seldom identified— type of deviance that seeks not only to circumvent norms but also to transform them in the process. Low-status French prosecutors who were frustrated with the political establishment, for example, broke rules of confidentiality by leaking high-profile cases of political corruption to the popular press in order to increase the external pressure on judges and release them from internal political pressures, pushing them to hear the cases. In so doing, they inadvertently shifted the balance of power in France (Adut 2004).

Knowing that certain structural positions will experience higher levels of strain, however, does not really explain why only certain individuals in those positions will break a rule. That is, the fact that an actor has a motivation to deviate does not mean that she will act upon that motivation or that she will be successful. The process through which that occurs, which is not only dependent on an individual's *willingness*, is just as important as the action itself (Matza 1969). In the French case, for example, it may be clear why prosecutors felt the pressure to push for a change in their marginalized status; but it is likely the case that there were several other professional groups with the motivation to change the status quo and who had specific ideas of how the system could be changed. In addition, it was the strategy of *one* of the prosecutors that, through its success, was widely imitated and shaped the French institutional landscape. Because different prosecutors probably had different ideas of how to proceed and they were possibly coexisting with other individuals from other professional groups who also had ideas for change, it would be useful to understand the mechanisms that allowed different prosecutors, and not other professionals, to test their ideas and why that particular one was the first to succeed.

This may help answer the second question, which relates to the ability to deviate. Different types of deviance require different types and levels of discretion. Within organizational settings, for example, it is often the case that actors with intermediate

status will be much more constrained and will pay higher costs for deviance, so only members with very high or very low status would be expected to deviate (Podolny 1993; Phillips and Zuckerman 2001). Accordingly, discretion and deviance are sometimes found at the "street level" where norms can't possibly anticipate all needs (Lipsky 1980; Canales 2006) whereas sometimes it is in higher levels that actors have the discretion to stray from norms (Vaughan 1999; Grojean *et al.* 2004; Zuckerman and Turco 2007). At the same time, it is precisely high status members who are likely to benefit more from existing institutions and have lower incentives to change them (Immergut 1992; Clemens 1993; Deeg 2005; Streeck and Thelen 2005b). Additionally, increasing levels of status may entail increasing costs and therefore larger constraints on potential deviance, as they could result in dramatic "falls from grace" or stigmatization (Adut 2005). Alternatively, high status members are both more visible and expected to fully embody the norms of their group. As a result, should these members deviate from norms they will face stronger contestation and much fiercer punishment (Clemens 1993; Phillips and Zuckerman 2008). It follows that, in institutional entrepreneurship, there is an inherent tension between a strong motivation to experiment and the discretion to bend or break existing rules, which means that not all structural positions will be equally conducive to it.

Finally, institutional change requires *organized action*. Because institutions at least partly determine the access to resources that different groups and organizations will have, any process of institutional change is likely to be highly contested (Clemens 1993; Ingram and Rao 2004). Additionally, because change comes from a shift in public beliefs, only experiments where several actors are engaged and learn about unexpected results will engender change; but such experiments require coordination, communication, and diffusion. Only through the use of the general strike as a coordinating symbol, for example, where French trade unions able to fully unleash the realignment of their labor movement (Ansell 1997). It follows that, in order to successfully promote institutional change, an institutional entrepreneur would need to convince enough actors to also engage in experimentation or, at the very least, to sanction her efforts (Colomy and Kretzmann 1995). In a complex environment where both organizations and different actors within organizations are in a position to contest a desired institutional change,

coordinating the efforts around a change project and handling the potential and actual contestation it may generate would require, at a minimum, a significant amount of social and political skill (Fligstein 1997; Beckert 1999; Fligstein 2001). More concretely, to bring new information –encoded in cognitive scripts—to a particular system, actors need to import scripts that have been legitimized in other social instances and recombine them in creative ways through a process of "bricolage" (Padgett and Ansell 1993; Parkhurst Ferguson 1998; Padgett 2001; Rao *et al.* 2005). The usage of previously legitimated scripts allows actors to experiment without encountering absolute resistance. When Edison introduced electric lighting, for example, he was successful because he developed a system that integrated as many as the key characteristics of gas lighting as possible, even when that meant reducing the performance of his superior technology (Hargadon and Douglas 2001). As some of these recombinations generate successful results, they are diffused through imitation (DiMaggio and Powell 1983; Barley 1986; Edelman 1990; Haveman 1993; Barley and Tolbert 1997) and an endogenous process of structuration begins, thus institutionalizing new practices (Edelman *et al.* 1999).

Conclusion

Two things emerge from this discussion. First, institutional change is initiated by individuals. Existing conceptions of institutional change, however, are not well equipped to provide a systematic understanding of this and, as a result, are at best incomplete but likely also incorrect. Second, a successful institutional entrepreneur must manage a delicate balance between a strong motivation to experiment on existing norms, the ability to garner enough resources to engage in experimentation, the discretion to use those resources, and the power and skill to prevent or mitigate overpowering contestation.

Existing accounts of institutional entrepreneurs in fact portray such a delicate balance, where significant (in some cases unique) skill is matched with an advantageous structural position and a favorable environmental opportunity. Caro's books on the rise of Lyndon Johnson through the senate, or Ansell and Padgett's description of the rise of the Medici are two of several good examples (Caro 1982; 1990; Padgett and Ansell 1993; Hargadon and Douglas 2001; Padgett 2001; Munir and Phillips 2005). A problem, however, stems from the fact that all these accounts must rely on the retrospective analysis of single

success cases. Instances of clear institutional change are, by definition, uncommon. Accordingly, scholars that seek to study the role of institutional entrepreneurs must typically rely on a change that has already occurred and analyze it retrospectively, tracing back, from the end point of the change to its inception, the *successful and recorded* actions that individuals took. Because they can only observe the particular path that recognized (successful) entrepreneurs took to achieve change, other (potentially unsuccessful) agents and their actions tend to be less present as counterfactuals (Fearon 1991; Mahoney 2000; George and Bennett 2005) and, because of the linear path they portray, they tend not to show true contestation or failed experimentation (Hall and Taylor 1996; but see Hargadon and Douglas 2001; Munir and Phillips 2005).

As a result, we fail to see what other actors who (most likely) perceived the same opportunities did to pursue them; or why actors that held similarly advantaged structural positions chose not to act on the opportunity, acted upon it and failed, chose not to oppose the successful entrepreneur and went along, or simply did not perceive the juncture in the first place. What we are left with is the conclusion that these institutional entrepreneurs were exceptional individuals in exceptional situations, which makes it hard to abstract systematic inferences to inform other past or future processes of change. Put differently, because we can't see whether other individuals who were positioned in similar structural positions failed to take advantage of them–even though some of them may have tried—or whether other actors with similar skills were limited by their structural position; it is hard to truly identify the specific skills and the particular elements of the entrepreneur's position that were determinant in their success. This is problematic because not identifying them in a systematic way can only leave us with the hope that a Cosimo or a Lyndon will emerge to change an institution that requires it.

The question, then, should not only be *who* is an institutional entrepreneur but also *how* it is that she becomes one. That is, under what conditions will a *potential* institutional entrepreneur *actually* turn into one? From the discussion above, it follows that two separate elements remain at issue. The first is the question of what triggers an actor's decision to seek institutional change. Specifically, as an opportunity emerges that

increases the potential benefits to experimentation, how do actors solve the binding constraint of pluralistic ignorance, which makes it impossible for them to even calculate the potential costs of their experimentation, let alone seek ways to minimize those costs? The second is, conditional on having a better sense of the costs involved and making the decision to engage in experimentation, what allows certain individuals to succeed while most fails? That is, what is the process through which certain institutional entrepreneurs overcome the barriers to institutional change?

These questions require us to understand how specific qualities of certain individuals enable them to perceive opportunities for change, how the social structure determines the resources and capabilities that these individuals will have at their disposal to pursue that opportunity, and how their qualities and the structure interact to determine whether they will be successful. To develop such an explanation inductively, we would ideally seek to observe a full set of individuals who are at risk of becoming institutional entrepreneurs when an opportunity arises[7] and follow them through time. We could then observe why only some of them detect an opportunity for change (and could therefore be considered potential entrepreneurs), why a subset of them actually seeks to enact a change, and why only a minority succeeds in its efforts. Note that such an effort would require a broader view of institutional entrepreneurship that allows to look at institutional change as a sequential –rather than a linear—process and to observe successes *and* failures at each stage. Otherwise, analyzing only successful cases would make it impossible to disentangle which observed characteristics, structural conditions, and actions truly determined success as we would not know whether other individuals had similar characteristics, faced similar conditions, or performed similar actions but were nevertheless unsuccessful. It is a risky proposition, as it entails analyzing processes of institutional change before it is clear that they will actually reach fruition. At the same time, it is often the analysis of failures rather than successes that yields the most useful insights.

[7] It may reasonably be argued that opportunities may be created, rather than simply detected, by institutional entrepreneurs. Two clarifications apply. First, it still holds that we would ideally like to observe the process through which those opportunities were created in the first place. Second, individuals still face the choice of *when* to create the opportunity for change. That is, what may arise is the environmental (social, political, economic) window to create an opportunity.

Such an approach, and following from the above discussion, would first put to rest the question of the uniqueness of institutional entrepreneurs. If the propositions presented here are true, and if it is indeed the case that only public beliefs converge in institutions, then observing a full risk set of actors should first show that, in fact, many of them think about institutional change and constantly seek for opportunities to engage in it. We should also observe that, contrary to traditional views, a relatively large number of individuals actually engage in institutional entrepreneurship but, as they advance in their efforts, they encounter different roadblocks that only allow some of them to succeed. In particular, we would expect that, at different points in the change process, different aspects of their personal characteristics and their structural position would become salient in determining their success. The challenge would then be to understand the mechanisms through which these personal and structural aspects interact to allow certain individuals to produce sweeping change.

That institutions, like all social structures, constrain and enable actors in ways that not only determine the options available to them but also perpetuate current structures and sow the seeds of future ones is a basic tenet of the social sciences. Until we unpack the specific mechanisms through which actors are shaped, limited, and empowered by their position in the social structure to affect the institutions that surround them, we will continue to rely on an incomplete understanding of how our society evolves.

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Chapter 2

Small Business Finance in Mexico:

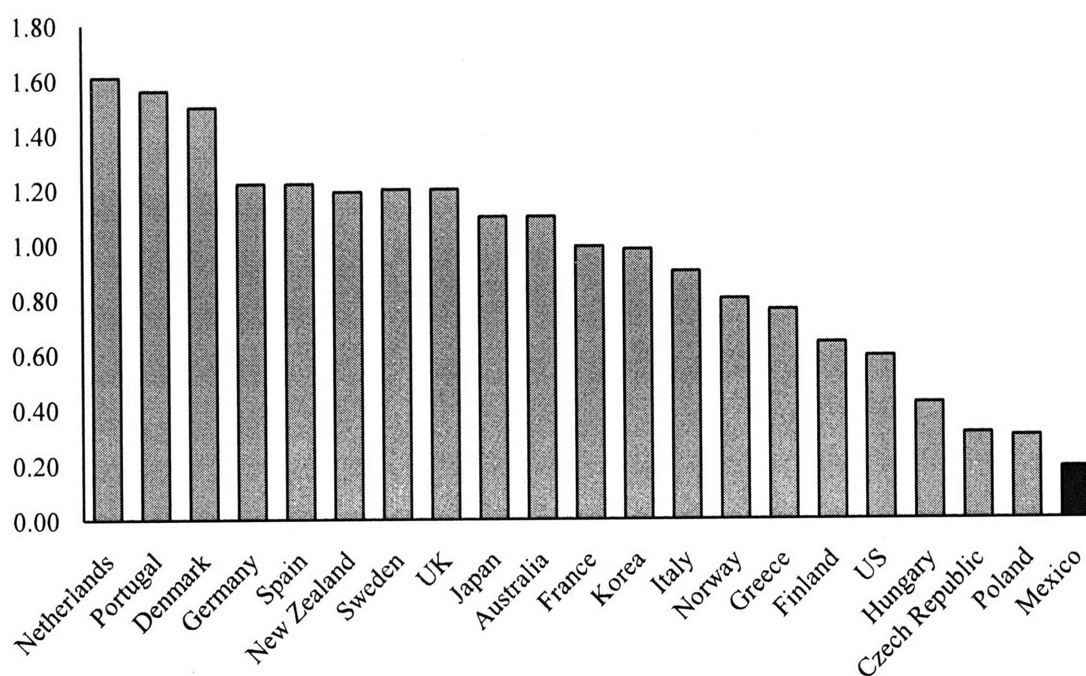
History and Institutional Constraints

Mexico and SME financing

Before 2000

Mexico is often cited as an exemplary case of poor financing environments: it has the lowest level of commercial lending as a percentage of GDP of all OECD countries, and one of the lowest in Latin America (see fig. 1a and 1b). Moreover, far from improving, the ratio has been decreasing over time (see table 1).

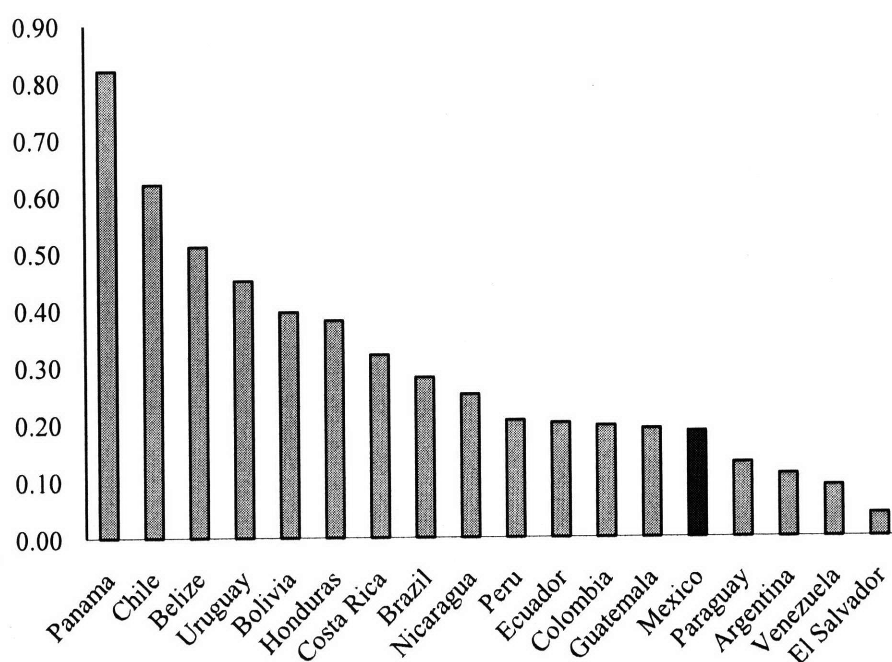
Fig. 1a.- Private Credit, % of GDP in 2003 (OECD)



Mexico is in fact a "poster child" for the now consensus view that the health of financing environments depends on solid institutions. Property rights, for example, are often cited as one of the most important institutions for financial development (La Porta et al. 1997; 1998; Johnson et al. 1999; de Soto 2000; Johnson et al. 2000; Acemoglu et al. 2002). Mexico's property right system is extremely complex and cumbersome. Each municipality has its own public property registry and records have only been centralized at the State level. Several states have yet to digitize their records, and response rates for new registries, inquiries, or registry changes are both widely diverging from state to state,

and extremely slow even in the best cases (ITAM and GMA 1999; Laeven and Woodruff 2004). Additionally, contract enforcement and judicial procedures are unpredictable, unreliable, cumbersome, fraught with corruption and complexity, and subject to high degrees of local discretion (Laeven and Woodruff 2004; Gamboa-Cavazos and Schneider 2007). As Laeven and Woodruff argue, while in Western Europe institutional environments vary from good to very good, in Mexico they vary from bad to less bad (Laeven and Woodruff 2004).

Fig. 1b.- Private Credit, % of GDP in 2003 (Latin America)



In parallel, and partially as a result of this, the Mexican banking sector has been historically concentrated and uncompetitive. From its origins, Mexican banks have been at the center of the Mexican political system, and have monopolized the country's financial resources (Centeno and Maxfield 1992; Schneider 1997). From the early twentieth century, there has been a tacit (and often not-so-tacit) agreement between the banks and the government, where in exchange for a certain level of liquidity and financing activity, the state grants the banks an oligopoly over financing (Maurer 2002; Haber *et al.* 2003). The arrangement proved relatively successful and effective through the twentieth century, until severe macroeconomic mismanagement led López Portillo's

government to expropriate all private banks in 1981[1] in an attempt to "blame the country's desperate economic situation on the country's bankers, rather than on his government's mismanagement of the economy." (Haber 2004).

Table 1.- Private Sector Lending 1997-2005
(Constant 1993 Pesos in Millions)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	CHG.
Banks*	118830	113820	90073	90606	81934	83320	79303	91075	95950	-2.6%
Development	81969	80198	69262	62622	56406	62647	56955	46196	37589	-9.3%
Other***	10680	10735	9386	11007	11942	13055	12535	13923	16658	5.7%
Total	211480	204753	168721	164235	150282	159021	148793	151194	150197	-4.2%
% GDP	14.5	13.7	10.7	9.9	9.2	9.6	8.8	8.5	8.2	

Source: CNBV (2005) and Banco de México
*Banks : comnercial credit
**Development: Disbursed by Development Banks for Target Sectors
***Other: Non-bank intermediaries

As a result, when the Salinas government decided to privatize banks as part of its broader privatization strategy in 1991, there still remained a fear of expropriation among investors. Given the government's desperate need for resources due to aggressive expansionary policies, it sought to auction the existing banks at the highest possible price. At the same time, investors were weary both because of the poor administrative condition of the banks and the impending threat of expropriation. To attract investors, Salinas granted them a protected oligopoly shielded from internal and external competition (Haber 2004), sold the banks to the highest bidder irrespective of managerial experience (Unal and Navarro 1999), did not bring Mexico's accounting standards in line with generally accepted accounting standards to allow banks to under-report non-performing loans (Haber 2004), allowed investors to pay for up to 75% of the negotiated value with debt acquired through loans given by the *same* bank (Mackey 1999), and unofficially promised extremely generous deposit insurance. As a result, Mexican banks sold with a premium of 45 percent over the value of their equity (Unal and Navarro 1999); and an impenetrable oligopoly ran by less experienced managers[2] was created which, due to

[1] This was in fact the third time that banks were expropriated since 1915. The two previous times, however, occurred during the highly turbulent times that followed the Mexican Revolution and preceded the creation of the national economic and political pact that gave rise to Mexican corporatism and the PRI's hegemony.
[2] Most of these managers did not have previous banking experience. Rather, they emerged out of trading companies and investment banks that developed during the stock exchange boom.

pervasive tunneling,[3] misreporting of non-performing loans, and moral hazard was highly volatile (Gonzalez-Hermosillo *et al.* 1997; Haber 2004). Indeed, while Mexico's 1995 currency crisis precipitated the banks' collapse, many authors argue that it would have happened regardless. The privatization, then, only changed the hands that owned the banks, without changing the institutional arrangements around them.

Aside from the resultant crisis, the institutional setup had other practical implications. Between the nationalization of 1981, the privatization of 1991, and the years leading up to the 1994 crisis most banks lost their credit analysis capabilities and the incentive to engage in commercial lending. This resulted from two related causes. First, in previous decades, bank lending had traditionally been carried out at the branch level, where branch managers had both the credit analysis expertise and the discretion to grant loans through their executive network, following a traditional model of relationship lending (Berger and Udell 2002). As the banks were first expropriated and later re-privatized, the administration was increasingly centralized and much of the credit analysis expertise was lost, as well as the "soft" client information that accompanied it.[4] What little discretion was still available to branch managers was lost when the 1994 crisis led to a complete centralization and tightening of lending.

After the crisis, which led to an expensive governmental bailout of all banks and a desperate need for capitalization of the system, Mexican banks were opened to foreign investment in 1997. Foreign ownership of Mexican banks increased from 16 percent in 1997 to 83 percent by 2004 (Haber and Musacchio 2005). The market was also further concentrated, where the five largest banks gained control of around 70 percent of the market.[5] However, this costly injection of capital was not accompanied by improved banking practices. While there was hope among business groups and NGOs that the internationalization of the banking system would bring increased competitiveness and

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[3] Tunneling refers to the provision of bank loans to the bank's shareholders, often for businesses that would otherwise not qualify for a loan

[4] Soft information refers to information attained through personal interaction and contacts. It is often cited as important In the case of SME lending given that smaller firms often have less collateral, messy and obscure financials, and shorter credit histories, among other limiting features.

[5] Source: Comision Nacional Bancaria y de Valores (www.cnbv.gob.mx)

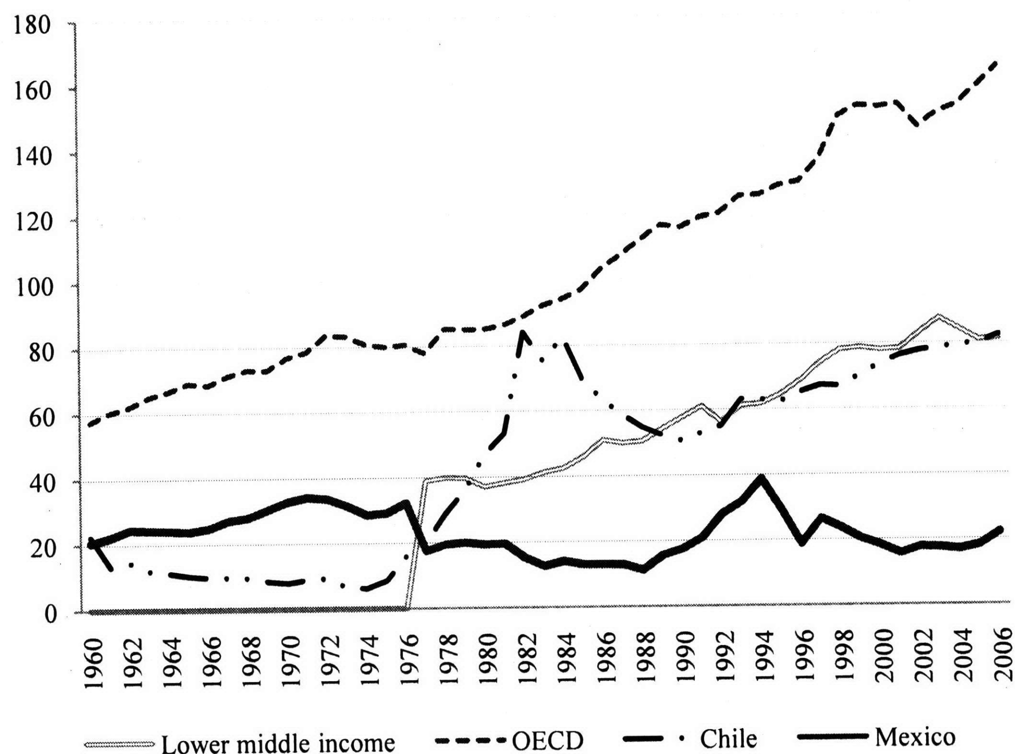
lending, the opposite occurred: international banks were quick to adapt to the Mexican conditions and became more, rather than less, risk adverse in their lending practices (Haber 2004; Haber and Musacchio 2005). The downward trend in commercial lending continued, with little incentive for the banks to change it. Large banks still maintain an oligopoly, they are comfortably placed in the middle of the political structure, and as a system they are one of the most profitable in the world through lending to the Mexican government and charging high commissions and fees (Standard and Poor's, 2007).

Looking at Mexican SMEs in particular, their lack of access to financing has a long history. Up to 1985, development banks in Mexico such as NAFINSA and Banrural played a central role in business financing through several government-sponsored funds. While their aim was to complement the role of commercial banks, in most cases they actually substituted all SME financing within the import substitution philosophy of the 70s and 80s. Due to several structural and contextual factors including the repeated financial and macroeconomic crises, as well as the nationalization of the banking sector mentioned above, these agencies lowered their activity considerably during the decades of the 80s and 90s. Commercial banks could not step in to fill the financing void due to their lack of organizational capabilities and the crowding-out effect of government credit. After the 1994 crisis, private credit suffered a dramatic shock which affected all sizes and types of businesses, not only not growing but in fact shrinking at increasing rates between 1997 and 2005. Private credit through bank and non bank financial intermediaries decreased at an annual rate of 4.2 percent in real terms. As a percentage of GDP, it fell from the already low level of 14.2 percent in 1997 to 8.2 percent of GDP in 2005 (see table 1).

While it is true that private credit began to take off after 2003, its amount in 2005 was only 71 percent of that in 1997, which was already at dramatically low levels and well below international benchmarks (See fig. 1c). SME credit suffered the largest decline, given that development banks had been the only ones providing some financing to SMEs, so even when private banks began activating credit again, the trend did not reach SMEs. As a result, Mexican businesses perfected the art of survival without financing. Around

seventy percent of Mexican businesses finance their operations through trade and supplier credit, which carries costs of 100 to 150 percent per year (Banco de México, 2007), which is consistent with other poor financing environments (McMillan and Woodruff 1999; Banerjee *et al.* 2003; Banerjee and Duflo 2004). An extra 15 percent of business financing comes from alternative credit sources such as personal credit cards, which are equally inefficient.

Fig. 1c.- Private Credit, % of GDP



This is especially problematic for Mexico as it is often cited as one of the World's most entrepreneurial countries in terms of the percentage of its population that has started or is in the process of starting a business venture (Reynolds *et al.* 2002). Yet, there is evidence that Mexican institutions are not friendly to entrepreneurs. It is estimated that between 60 and 90 percent of new ventures are started in the informal sector (INEGI, 2008). It takes entrepreneurs an average of 36 days and 20 percent of per capita GDP to open a business, in contrast with the US's 5 days at a negligible cost (WorldBank 2007). Moreover, while small businesses are proliferating, they do not seem to be growing, as demonstrated by

shrinking numbers of medium enterprises and registered employment within them (Fox 2000). Over 98 percent of all Mexican businesses are SMEs, and 95 percent of them are small businesses (Economia 2005). This is in contrast to the United States, where only about 78 percent are SMEs. As a percentage of the total firms, the number of large firms with more than 500 employees is about eight times larger in the United States than in Mexico (Laeven and Woodruff 2004). Thus while Mexico has had entrepreneurship, it has not seemed to have the kind required for vibrant economic growth (Baumol 1990). Table 2 presents selected indicators of the institutional environment for doing business in Mexico and shows its relative lack of competitiveness compared to other countries.

Table 2.- Selected Cross-Country Doing Business Comparisons (2006)

Metric	OECD	Region	Brazil	Chile	Mexico
Ease of doing business index (1=best)	..	..	121	28	43
Business disclosure index	6.1	4.2	5	8	8
Investor Protection Index	5.9	4.5	5.3	5.7	3.7
Director Liability Index	5.1	3.8	7	4	0
Shareholder Suits Index	6.6	5.7	4	5	5
Legal rights Index	6.3	4.4	2	4	2
Private credit bureau coverage (% of adults)	60.4	27.5	43	19.3	69.5
Credit information index	5.0	3.4	5	6	6
Firms using banks to finance investment (%)	..	..	..	28.97	2.61
Time required to start a business (days)	16.0	77.3	152	27	36
Cost of business start-up (% GNI per capita)	5.7	53.1	9.9	9.8	14.2
Procedures to enforce a contract (number)	22.1	38.8	42	33	37
Time required to enforce a contract (days)	370.7	654.6	616	480	415
Cost (% of debt)	10.6	23.3	15.5	10.4	20.0
Procedures to register property (number)	4.7	6.6	14	6	5
Time required to register property (days)	35.9	78.7	47	31	74
Cost (% of value)	4.8	4.8	4	1.3	5.3
Management time dealing with officials (%)	..	..	..	9	20.49
Unofficial payments to gov. officials (% firms)	..	..	..	8.17	20.01

Source: World Development Indicators, World Bank

These institutional deficiencies created challenges for the Mexican government beyond SME financing, and certain reforms have been sought. A good example is the reform of the bankruptcy and debt collection regulation pursued in 2000. This reform sought to improve corporate insolvency proceedings which had been regulated by the "Ley de Suspensión de Pagos" since 1943 with severe deficiencies (Gamboa-Cavazos and

Schneider 2007). The new law achieved impressive results in relative terms, even if in absolute terms the institutional environment is still uncompetitive. Average time spent in bankruptcy decreased from 7.8 to 2.3 years, average recovery rates for creditors increased from 19 to 32 cents on the dollar, and there was a decrease in the frequency of APR[6] violations from 29 to 2 percent (Gamboa-Cavazos and Musacchio 2006; Gamboa-Cavazos and Schneider 2007). While these reforms certainly improved the overall regulatory landscape, and they surely paved the way for future developments, they did not activate the lending market. On the one hand the property rights system is still underdeveloped and the Mexican court system, though better regulated, is still perceived to be subject to manipulation and corruption (ITAM and GMA 1999; Laeven and Woodruff 2004; Gamboa-Cavazos and Schneider 2007). On the other hand, and more importantly, Mexican banks were still disinterested in SMEs as a segment and had no credit product available to them. Business credit continued to decrease even as these legal reforms were passed and implemented. This would suggest that barriers to business credit went beyond legal institutions, as we would otherwise expect that improvements in them would lead to marginal shifts in lending activity, especially given the size of the potential market.

The above discussion suggests that the Mexican banking system is extremely dysfunctional and impervious to change. Indeed, Mexico is widely studied for its institutional failures both at the financing and at the political levels, where recent democratization has led to a considerable degree of political gridlock. It is thus a good instance of a critical, or least likely case, where institutional change would be least expected to succeed (George and Bennett 2005). SME credit in Mexico existed in 1994 but only through clientelistic government programs that remained insignificantly small. With the crisis it literally reached a level of zero. After 1997 there was a small increase in lending activity (in the dozens, not even hundreds of loans) and the levels remained there until 2002, when an impressive shift in lending activity occurred.

[6] Absolute Priority Rule

After 2000

Two important trends have dramatically altered the small business financing environment in Mexico in the last decade. The first is the activation of the small business lending market through the banking sector. The second is the (late) explosion of microfinance in the country. Both will be discussed briefly below.

The SME Credit Market

Table 3 shows a dramatic break with past trends and a sudden burst of growth in SME lending. It is important to note that the bulk of these loans were granted through the same large banks that have dominated the Mexican financial sector, that had purposefully stayed away from SME lending, and that face considerable internal constraints given their size and complexity. It is also useful to keep in mind the kinds of internal hurdles and structural adjustments (even without arguing for a deep organizational change) that would be needed to overcome to give out this amount of loans.

Table 3.- SME loans by year

Year	No. Of Loans	Cumulative	% Default	Average Loan	% of SMEs+	Total SMEs (IMSS)++
2002	600	600	7.0%	$266,606	0.1%	811,244
2003	8,382	8,982	5.9%	$271,572	1.1%	807,642
2004	22,875	31,857	1.4%	$333,885	3.9%	803,902
2005	41,512	73,369	1.2%	$296,769	8.5%	866,105
2006*	33,061	106,430	0.2%†	$231,684	12.3%	
2006**	44,081	117,450	0.2%	$231,684	13.6%	

* Only includes the January-September period 2006
** Projected, assuming a continuing linear trend as the one observed from January to September
+ Cumulative loans as a percentage of total registered firms
++ Number of registered SME firms at the IMSS –the National Social Security Institute—as of December of that year. 2006 assumes the same number of firms as 2005.
† Note that delinquency rates are usually "lagged" –they take time to manifest themselves, this is certainly an underestimation of the true 2006 expected delinquency rate.

There is also evidence that a significant amount of change occurred within the internal structure of the banks. Before 2002, none of the Mexican banks had a specific business credit analysis area or a group focusing on SMEs and there was certainly no credit product designed for SMEs. All credit analysis was focused on consumer credit (credit

cards) and SMEs were not targeted as a specific segment, as their deposits and products were usually aggregated with those of individuals. As of 2006, all Mexican banks have a specific SME area and its corresponding structure, including an SME-specific credit analysis area. In some cases (two of the largest), banks have started to shift from the traditional model of generic branch executives to one which includes a special team of SME executives embedded in the branch structure. There are now more than twenty-five credit products specifically designed for SMEs. Table 4 shows a sample of the newly formed SME-specific products, none of which existed before 2000. It can be seen that a diversity of products matching different client needs can be found in the market today. Moreover, three of Mexico's main banks (Banorte, HSBC, and Santander) today claim the SME segment as their priority and the central piece of their growth strategy. The increased activity in the credit market and the increased pressure that banks have placed on regulators has also resulted in additional changes in legislation, as can be seen in table 5. Note that most of these regulatory changes occurred after the credit market had taken off (several of these reforms are yet to become active).

Given the remarkable stability of the practices and structure of the Mexican banking sector (even in the face of dramatic changes in their environment), their historic reticence towards commercial lending, and their lack of internal organizational capabilities to engage in SME financing this sudden emergence of a market where there was none demands explanation. In fact, and as I will show below, it can be traced back to a government program launched in 2001, called the National Financing System (SINAFIN). The program evolved and changed considerably from its inception in 2001 and its initial implementation in 2002, but it basically consists of a government-funded guarantee system that subsidizes the banks' lending risk through coverage of SME loan losses.[7] This, however, raises the additional question of how a transformative program could emerge under such adverse conditions and how it managed to succeed. That is,

[7] Operationally, the SINAFIN offers two types of guarantee products. The first is a first-losses product that covers a set percentage of a bank's SME loan portfolio, where each defaulted loan is automatically recovered in its totality up to the specified percentage of total losses, based on an estimated total committed portfolio. This product is offered at practically no cost to the banks, as they only have to pay a minimal percentage to cover operational costs. The second is a traditional guarantee that covers up to 75 percent of each loan that defaults, but that has a cost of around two percent of the guaranteed amount.

even if the program was indeed the initiator of change, there must be more to the story than its simple existence.

Table 4.- SME products by bank

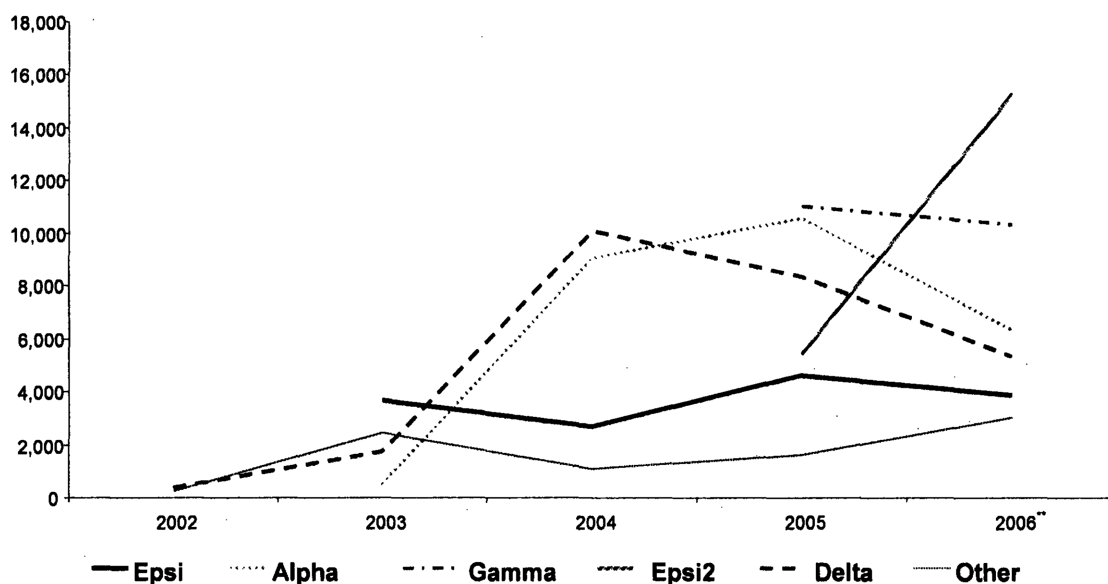
Bank	Interest rate+	Maximum Amount	Maximum maturity	Collateral / Guarantee	Firm Age	Financials required
HSBC	15% - 24%	1,500	18	None	1 - 2	Last 2 Years
BBVA	TIIE + 8.32	1,000	24	Personal	1	Last 2 years
Santander	18%	1,000	36	Personal	3	Last 2 years
Banamex	TIIE + 11.4	550	Revolving	Personal	2	Last 2 years
Banorte	TIIE + 12	11,200	60	Mortgage or personal	2	Last 2 years
Scotiabank	TIIE + 8.4	2,700	Revolving	Personal	3	Last 2 years (Audited)
Bajio	TIIE + 6.5	999	36	Personal	3	Last 3 years
Banregio	19%	400	Revolving	Personal	6 months	Last 2 years
Ficen	TIIE + 15	5,000	60	Mortgage or personal	2	Last 2 years
Unicrese	TIIE + 12	250	36	Personal	3 months	1 year

Source: Ministry of the Economy
Note: This table includes a sample of banks and non-bank financial intermediaries
Note 2: All products require the firms to be officially registered as taxpayers
+ TIIE is the Interbank Interest Rate

SINAFIN was clearly a crucial element to activate SME credit, as reflected in table 2, but there are several reasons to believe that there is more to the story. First, while this marked the first time that a federal government agency sought to develop a comprehensive SME financing plan, there had been several previous efforts to finance SMEs, some of them using similar guarantee products. Traditionally, government-led financing programs had been run from public development banks such as NAFINSA at the federal level or through state-level development funds. Historically, however, the programs had constantly run into trouble because they became political tools and were deployed in typical clientelistic fashion, where loans were granted on political rather than business

terms and were rarely collected upon.[8] The SMEs, on the other hand, had built a culture of skepticism and outright fear of credit, especially after the financial crisis of 1995 when many of them literally lost their homes to the crisis; they didn't have information about the new products that the banks were offering; and, more importantly, they didn't really know how to handle a bank loan. Given the strong institutional legacy mentioned above, it is surprising to see a program suddenly succeed where other similar attempts had failed. Second, in its four initial years of existence, the entire investment in the program amounted to not more than US$150 Million ($1,800 Million Pesos). This is remarkable given the transformations required to place more than US$4 Billion in loans.

Fig.2 .- SME Loans by Year and Intermediary



** 2006 Projected assuming a continuation of the Jan-Sep trend – this underestimates the seasonality of the market

Third, as the design process of the program began, all major banks in Mexico were invited to participate. High-level members of the SE met directly with each of the banks' managers to promote the new directive and invite them to join in the process. While most

[8] On previous programs when the private banks were asked to participate, they demanded large guarantees and collateral over their loans both from the government and the entrepreneurs, as they perceived the SME segment to be of high risk, as well as economically unattractive due to the relative high intensity of labor required to service it. Additionally, as I have explained before, the banks' credit analysis processes and lending methodologies were not well suited for SMEs, as they had developed through years of lending to large Mexican and foreign companies and conglomerates, and to the government.

of the banks –and all the larger banks—expressed interest, only three of them managed to engage successfully in SME lending from the beginning of the program, while others did not (see fig. 2). But why did certain banks, and not others, choose to experiment? And what determined whether a bank would be willing to engage in the program?

Fourth, Mexico is a federation with a central Federal Government and thirty-two autonomous State Governments. For the SINAFIN, this meant that even though the program was launched by the federal government and was operated through national banks, each state government could both choose whether to actively promote the federal program *and* how to locally implement it. Mexico's states vary in several critical respects such as size, level of economic development, institutional environment, population size and characteristics, natural resources, business population, etc. It is therefore not surprising that we also find significant levels of variation when it comes to the state-level performance of SINAFIN.[9] Table 6 shows loan placement through SINAFIN for the different states, as well as some state characteristics such as GDP per capita, number of SME firms, number of bank branches per state, as well as some measures of institutional quality (Laeven and Woodruff 2004). The data presented in table 6 is sorted according to state performance in the SINAFIN.[10] Note that, while there is a wide variation between the states in the penetration that SINAFIN achieved (ranging from around 8% to as high as 25%),[11] this variation is not fully explained by structural factors such as the economic weight of the state (correlation of 0.35), the number of bank branches in the state (correlation of 0.3) or the institutional quality of the state (no significant correlation in either of the two measures).[12]

[9] Given that the goal of the SINAFIN was to promote SME lending and nothing else, a reasonable measure of the program's performance is the number of loans placed in a given state. More specifically, and given the large variation in state sizes, I am using a measure of penetration (number of SME loans placed relative to the number of SMEs officially registered with the national institute of social security IMSS) as a rough measure of performance.

[10] Except for the State of Mexico which is listed under Distrito Federal given that most of that state's loans were granted in the metropolitan area of Mexico City.

[11] These numbers may seem surprisingly high. It is important to keep in mind that these are percentages of all the firms that are registered with the IMSS (which were the only eligible firms for the program) which are a subset of existing firms (some firms are informal, some firms are formal but don't have any employees, and are therefore not registered for social security)

[12] Other measures, on the other hand, co-vary much more strongly, as would have been expected: The number of branches in a state is correlated with the state's economic size at a 0.98 level. The correlation of

Table 5.- Selected Reforms to the Prudential Framework and Financial Infrastructure

Law	Main Features
New Bankruptcy Law (2000)	•Introduced a single insolvency procedure (conciliation/reorganization phase, which can be converted into bankruptcy declaration). •Created a government expert body overseeing and facilitating insolvency proceedings (Instituto Federal de Especialistas de Concursos Mercantiles). •Assigned exclusive jurisdiction to federal courts over insolvency proceedings. •Limited the time for good faith negotiations after which liquidation has to start. •Allowed for greater flexibility and value maximization in deciding reorganization plans. •Permitted netting of financial derivatives •Clarified the ordering of creditors in case of liquidation.
Security Interest Package (2000)	•Introduced the pledge on movable property without transfer of possession (la prenda sin transmisión de posesión) •Regulated the security trust (fideicomiso de garantía). •Included provisions related to the enforcement and foreclosure of such security interest.
Amendments to the Credit Institutions Law (2001)	•Strengthened banking regulation and supervision. •Promoted transparency and competitiveness. •Fostered new financial products and services. •Strengthened credit institutions' corporate governance.
New Law on Regulated Credit Information (2001 amended 2003)	•Regulates the inception and operation of credit bureaus •Defines consumer rights related to credit bureaus. •Reform aims at eliminating conflict of interests by placing maximum ownership thresholds in ownership of credit bureaus.
Amendments to the Security Interest Package (2003)	•Eliminated non-recourse clause on the pledge on movable property without transfer of possession and on security trusts. •Introduced new rules to expedite commercial procedures, which include harmonization of commercial litigation procedures across different states. •Allowed expeditious out-of-court foreclosure of collateral on guaranty trusts. •Allowed the use of blanket lien on assets to non-banks. •Enhanced the collateral value of leased goods through enhanced repossession rules.
Law of Transparency and Ordering of Financial Services (2004)	•Regulated commission fees and other aspects related with the provision of financial services. •Prohibited discriminatory practices between credit institutions and between users; established transparency requirements in contracts and check account balances, credit and debit cards. •Created transparency mechanisms to allow clients of credit institutions to know about the value and fees of transactions.
Amendments to the Credit Institutions Law (2005)	•Established a system for prompt corrective actions based on banks' capital adequacy ratios consistent with international practices. •Facilitated access of enterprises to capital markets in order to fund their credit activities

Source: IMF Country Report No. 07/170

% GDP with branches per capita and branches per SME is 0.6 and o.42, respectively. GDP/cap is correlated with the number of branches at the 0.54 level, and with the judicial measures at a 0.3 level.

Table 6.- SINAFIN at the State Level

State	Number of Loans	% Reach[+]	Total Firms (IMSS)[++]	GDP / Cap	% of Natn'l GDP*	Bank Branches (2005)	Branches / SME	Judicial Efficiency[1]	Judicial Factor[1]	% Urban Population
Distrito Federal	25,250	25.49%	99,065	189.0	21.84%	1,461	13.93	2.5	0.2	98.6%
Mexico	10,177	20.16%	50,474	50.2	9.48%	781	14.34	3.2	1.0	73.0%
Chiapas	3,137	25.24%	12,429	29.9	1.70%	155	12.31	3.0	(0.2)	32.0%
Nayarit	2,050	20.46%	10,020	42.9	0.54%	60	5.69	2.5	(1.1)	44.0%
Tlaxcala	708	19.49%	3,630	40.3	0.57%	49	13.22	2.2	(0.9)	34.0%
Guerrero	2,251	18.69%	12,043	40.5	1.68%	163	13.04	1.7	(1.8)	40.4%
Zacatecas	1,697	18.10%	9,378	41.8	0.76%	89	9.38	2.3	(1.5)	37.0%
Michoacán	4,226	17.20%	24,574	41.6	2.21%	288	11.31	1.9	(1.3)	47.1%
Jalisco	11,920	17.08%	69,788	71.2	6.31%	730	9.82	2.4	0.4	73.8%
Yucatan	2,445	16.36%	14,939	58.9	1.41%	130	8.64	2.0	(1.8)	60.1%
Puebla	3,741	15.64%	23,919	49.5	3.55%	298	11.96	2.5	0.4	48.3%
Quintana Roo	1,805	15.48%	11,658	108.5	1.64%	103	7.89	2.5	(1.0)	75.5%
Morelos	1,524	15.39%	9,900	64.5	1.38%	130	12.83	3.3	0.6	60.9%
Nuevo Leon	8,453	15.30%	55,234	133.9	7.43%	615	10.34	3.0	0.5	90.6%
Durango	1,648	15.03%	10,968	66.9	1.33%	86	7.57	3.3	0.9	55.4%
Tamaulipas	4,588	14.51%	31,617	82.9	3.34%	293	8.82	3.0	1.4	80.9%
Aguascalientes	1,643	13.97%	11,760	87.7	1.23%	77	6.21	4.6	2.9	72.6%
Coahuila	3,810	13.99%	27,226	102.2	3.37%	249	8.70	3.4	1.0	85.2%
Colima	1,039	13.85%	7,501	71.3	0.53%	61	7.73	3.1	0.1	71.9%
Guanajuato	5,187	13.50%	38,426	55.1	3.60%	367	9.13	3.0	0.1	60.9%
San Luis Potosi	2,427	13.36%	18,162	56.4	1.81%	145	7.43	2.8	(0.2)	50.2%
Oaxaca	1,398	12.19%	11,467	32.4	1.52%	148	12.64	2.6	0.2	24.3%
Campeche	1,390	12.01%	5,271	123.4	1.24%	55	9.87	3.2	0.2	55.7%
Sinaloa	3,667	11.90%	30,813	57.2	1.99%	242	7.53	2.7	(0.2)	56.9%
Hidalgo	1,301	11.53%	11,281	41.9	1.30%	117	9.66	2.1	(0.2)	30.9%
Veracruz	4,462	11.35%	39,319	44.2	4.17%	396	9.74	2.2	(1.5)	42.8%
Chihuahua	3,581	11.07%	32,349	100.3	4.33%	296	8.75	2.7	(0.4)	78.8%
Baja California	3,969	10.84%	36,629	92.5	3.50%	274	7.26	3.1	0.7	85.1%
Tabasco	1,064	10.71%	9,939	46.4	1.25%	127	12.17	3.1	0.9	33.5%
Baja California S.	921	10.03%	9,181	87.1	0.60%	66	6.32	2.5	(0.6)	70.1%
Queretaro	1,412	9.16%	15,408	80.9	1.72%	119	7.01	3.2	0.1	51.4%
Sonora	2,599	8.44%	30,806	84.3	2.68%	240	7.73	3.1	0.5	75.1%
Correlation with Penetration	-	-	0.16	0.16	**0.35**	**0.31**	**0.45**	-0.14	-0.16	-0.05
Correlation with Penetration[#]	-	-	-0.23	-0.11	-0.16	-0.13	0.35	-0.16	**-0.24**	**-0.27**

[+] Accumulated loans in the State as a percentage of firms registered with the IMSS (Social Security)
[++] Total number of firms registered in IMSS as Micro, Small or Medium. Numbers valid for 2005
[*] Participation of State GDP in national GDP. GDP numbers in current pesos
[**] Correlation excluding Mexico City (DF and State of Mexico)
[1] See Laeven and Woodruff (2004)

Several questions arise from this section: How can we explain that such a relatively small program created such a broad institutional shift? Why were only some banks willing to experiment with the program? What determined that willingness? And how can we explain the varying levels of success that the program had in different states, when basic structural factors do not seem to fully explain them? As I argued above, Mexico is an institutional environment where we would not expect a change as the one we observed. For example, it is puzzling to see the banks suddenly participate in a segment that they had purposefully stayed away from; or embrace a governmental program similar to others they had previously turned down. This is especially the case given that the institutional, organizational, and political constraints that existed were significant and did not decrease during the Fox administration, if anything, they became more entrenched.

Chapter 3 and 4 of the dissertation tackle these questions through leveraging the unique temporal and structural characteristics of the SINAFIN program. The variation that exists in the program's results at the organizational and state level, as well as the fact that it is still ongoing and we can identify the specific agents who have been trying to use the program to generate institutional changes, allow us to gain insights into how change agents –or institutional entrepreneurs—emerge, why they decide to act, and why some of them succeed where others fail. One of the chapters –Chapter 3—provides a basic chronology of the program, as well as a description of its results, challenges, and main impacts. Chapter 4, on the other hand, delves into the process through which the program was designed and implemented to provide insights into the mechanisms through which institutions are changed by individuals –provided that they have the right backgrounds and are situated at the right structural positions.

Microfinance

A second dramatic transformation that has occurred in the Mexican financial sector is the explosion of Microfinance. Aside from the underdevelopment of bank credit, Mexico has faced an additional barrier in the fact that a large proportion of its population does not have access to basic financial services. Similar to other countries with high levels of inequality, there is a large gap between the relatively wealthy and the relatively poor in

their financial sophistication. Table 7 presents the income distribution of the Mexican population, while figure 3 presents the penetration of banks, measured as percentage of the population that has access to bank services (such as checking accounts, credit cards, etc.) by socioeconomic level. Given that a majority of the population in Mexico lacks access to financial services, and following the trend of the developing world, a number of organizations have emerged that provide financial services to the poorest (mostly in the form of credit, although savings and insurance are sometimes offered as well). In contrast with popular mechanisms such as informal savings groups (or ROSCAS) or previous programs run by governments with political goals in mind, these Microfinance Institutions (MFIs) use sophisticated tools and technology that allow them to increase the reach and scope of their service offering while maintaining a relatively nimble cost structure. They also maintain a strong focus on sustainability, which implies keeping a tight control on delinquency rates and the moral standing of their clients (Khandker 1998; Morduch 2000).

Table 7.- Socioeconomic Distribution of Mexican Population

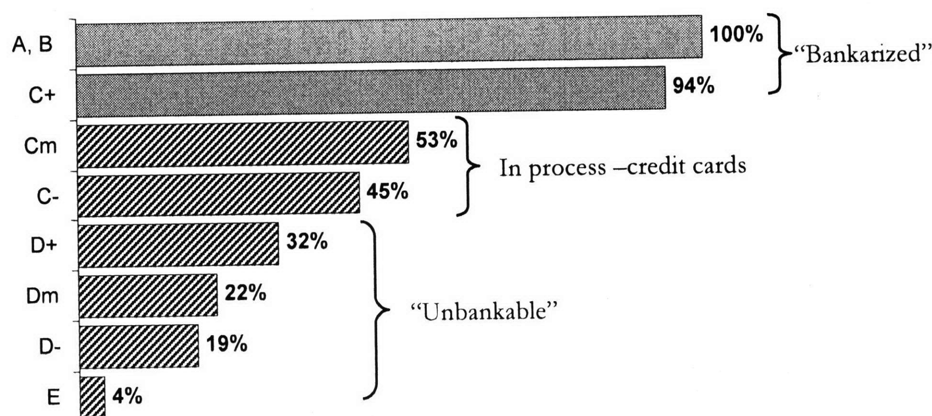
Level	Range of Salaries (Min)	Range of Salaries (Max)	Population (Millions)
A	>500		0.6
B	101	500	1.9
C+	30	100	3.4
C	15	30	6.4
C-	10	15	9.2
D+	7	10	12.9
D	4	7	16.3
D-	2	4	21.8
E	>1	2	31.4
Total			105.8

Source: "Providing Financial Services to Low Income Segments in Mexico". Sigma, Mercados Potenciales 2003-2004

The emergence and explosion of microcredit in Mexico has followed a roughly similar path to the one observed in other developing countries, but there are several peculiarities of the Mexican case that differentiate it. First, Mexican microfinance is relatively young. While activity in the sector began as early as 1989/1990 with the creation of Finca and Compartamos, the vast majority of Mexican MFIs emerged in the late 1990s and early 2000. This is in contrast with the rest of Latin America, where activity began in the early

1980s and several MFIs like BancoSol in Bolivia or MiBanco in Peru had already consolidated their operations and grown to become commercial banks specialized in microfinance by the early 1990s. It is in fact estimated that Mexican microfinance has a ten year lag with respect to the rest of Latin America (Christen 2000). This lag is intimately linked with the institutional constraints that affected the financial sector as a whole, as well as with the macroeconomic instability that plagued the country during its "lost decade" of the 1990s, which coincided with other countries' microfinance revolution (Alpizar and Gonzalez-Vega 2006).

Fig.3 .- Penetration of Traditional Banks by Socioeconomic Level



Source: "Providing Financial Services to Low Income Segments in Mexico" Sigma, Mercados Potenciales 2003-2004

Second, and related, the complexity of the Mexican regulatory framework has severely affected the development of microfinance. Similar to other countries, the MFIs that first started operations in Mexico in the early 1990s had a strictly non-profit approach and were constituted as NGOs. These organizations had an integral development approach and only offered financial services as an element within a larger set of services that included education, health, and nutrition. As their operations grew, however, the microcredit component of their services became dominant, both because it was the most demanded and because it was the only service that generated income and could grow in a truly sustainable fashion (Marulanda and Otero 2005). As NGOs, these MFIs were not regulated and could only rely on donors–and retained earnings—to fund their growth, precluding them from capturing resources through popular savings or through the market.

The macroeconomic crises that affected the country, however, kept donor flows at a trickle and MFIs grew at relatively low rates. As these NGOs –and other potential entrants—became increasingly aware of the commercial potential of microcredit a shift in MFI focus occurred. Instead of focusing on integral development with microcredit as a single component of a broader strategy, MFIs embraced a for-profit focus with microcredit at their core as a way to overcome growth constraints (Dugan and Goodwin-Groen 2005). Both former NGOs and (true or mock) altruistic entrepreneurs framed this new for-profit strategy as the best alternative to attract funding, grow aggressively, and achieve a broader social impact.

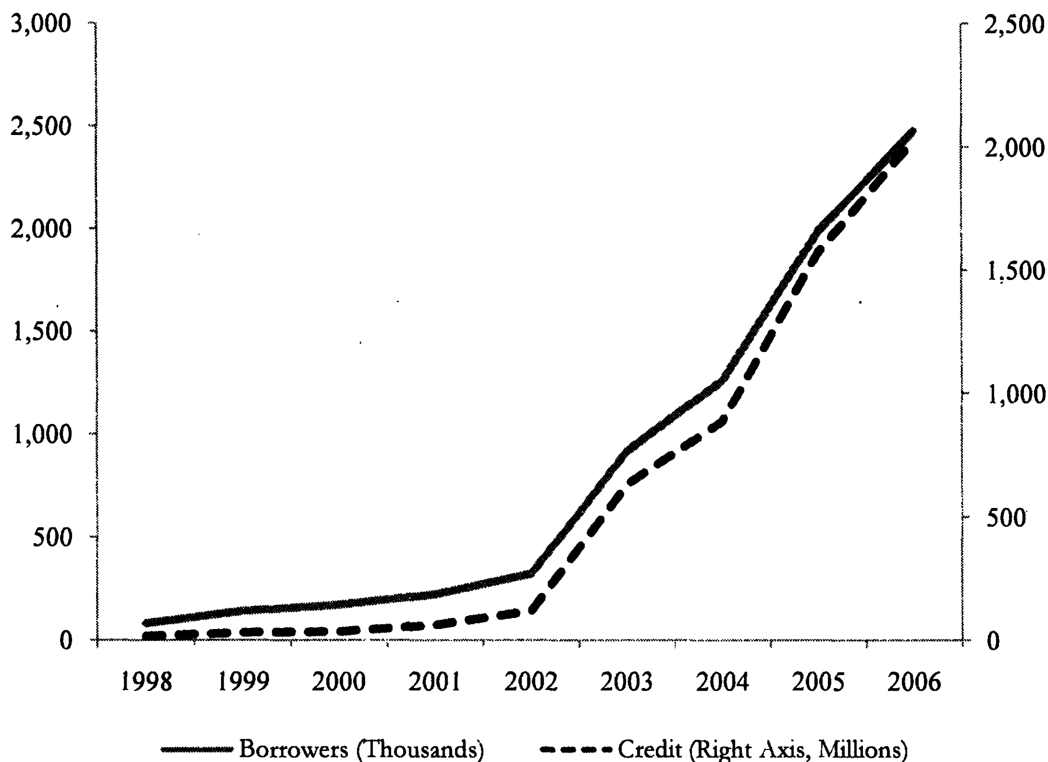
This shift towards a commercial view of microcredit, however, was not supported but in fact severely constrained by the Mexican regulatory system. Growing and emerging MFIs faced a broad array of legal forms that could be chosen, each of which had its own complexities and constraints. NGOs, for example, could not legally generate any profits and could not capture funding from the market, either in the form of savings or credit lines. There were at least seven for-profit legal forms to consider with different funding constraints (e.g. most could not capture popular savings), tax regimes, levels of regulatory supervision, and legitimacy amongst donors and potential clients (e.g. credit unions lost most of their market legitimacy during the 1995 crisis, when a vast majority of them collapsed, and were viewed with deep distrust by potential investors). As a result, MFIs engaged in regulatory arbitrage depending on their funding source, their specific market focus, and their legal expertise. Several firms even switched legal form as they experimented with different options (Alpizar and Gonzalez-Vega 2006).

Third, governments at both the state and the federal levels continued their participation – which initiated in the 1970s as described above—in the microcredit market. On the one hand, several development banks and agencies at the federal level continued to provide direct microcredit services, especially in rural areas, with political goals in mind and following clientelistic practices. Other federal agencies shifted their focus to second-tier financing providing different levels of subsidies or cash transfers but unclear assignment rules. On the other hand, state governments also participated in microcredit with widely

diverging strategies, ranging from entirely clientelistic programs to states that followed international best practices and removed themselves entirely from the market, only facilitating private efforts. The complexity of this array of government interventions was such that, to this day, no complete registry has been achieved (Villafani-Ibarnegaray and Gonzalez-Vega 2006a). The number and diversity of government interventions generated not only confusion but also diverging levels of market distortion, further limiting the incentives for private efforts (Villafani-Ibarnegaray and Gonzalez-Vega 2006b).

These factors have, not surprisingly, impacted the development of Mexican microfinance in several ways. First, Mexican MFIs emerged as a result of the global expansion of microfinance and they accordingly sought to follow international best practices in lending methodologies, organizational structures, and technology. However, the regulatory and market intricacies they encountered limited the extent to which international lessons and cutting edge practices could be adapted. That is, while the basic structures were indeed imported, nuanced lessons and best practices were much harder to import, even for MFIs that belonged to broader international networks such as ProMujer or WorldVision (Nagarajan and Meyer 2005; Alpizar and Gonzalez-Vega 2006). Accordingly, Mexican MFIs have not been able to take full advantage of international learning, they have had to follow their own process of experimentation to develop a set of workable policies, and have not fully converged on a set of best practices. Second, the market (until very recently) has been relatively concentrated in a few dominant players, especially in certain states. Given strong economies of scale in microcredit, initial concentration generated a 'Matthew effect' that has further decreased competition and market penetration. This has been especially strong in states with lower urban concentration and with lower levels of financial sophistication. At the same time, this same dynamic has generated too much competition in urban markets where emerging MFIs find it easier to reach large numbers of clients with relatively lower investments.

Fig.4 .- Selected Results for Mexico's Leading 28 MFIs



Recent developments, however, have dramatically changed these dynamics. The most important of these was the passing of a new Popular Credit and Savings Law (Ley del Ahorro y Crédito Popular) in 2001 –but put in practice in 2006—which created a single, more versatile and clearer framework for MFIs. The law allows for the creation of Popular Finance Societies (SOFIPOs) which can seek an array of financing options – including popular savings—to provide financial services. In addition, a new, unregulated legal form (SOFOM) was created for firms seeking to engage only in credit activities. These two new legal forms have both increased the flexibility of MFIs and reduced the diversity of options. Furthermore, the Fox Presidential administration (2000-2006) sought to increase the depth of the microfinance market by launching a new set of government initiatives. On the one hand it provided more second-tier financing through a new agency (PRONAFIM) and through disbursing more funds through traditional agencies (e.g. NAFIN). On the other hand it provided significant technical (and economic) assistance through Bansefi. These efforts were significant and facilitated the creation and expansion of new players, but were still mired by the diversity and complexity of government

programs. Finally, the growth and especially profitability experienced by the largest players, as well as their international prominence, has attracted much investment in the sector. As a result, what we see is a microfinance market that started developing late (in the mid 1990s), grew at relatively sluggish rates for a number of years, and then suddenly took off in the beginning of the decade. Figure 4 presents the results of the 28 leading MFIs in Mexico, captured by MixMarket[13] and clearly shows this trend.

This historical evolution makes the Mexican case an interesting one to study for several reasons. First, given its late emergence, a relatively narrow set of international best practices had already emerged and there were quite specific expectations of what a legitimate MFI should look like, what lending structures it could use, and what its objectives should be. Second, the financial crisis of the mid 90s greatly affected both liquidity levels in Mexico and national investors' confidence. As a result, emerging Mexican MFIs were especially dependent on foreign donors and therefore experienced additional pressure to conform to international expectations and to comply with institutionalized forms. Third, the large amount of market and regulatory uncertainty that these MFIs encountered created a strong discrepancy between donors' expectations, formal rules and goals, and actual market conditions and organizational needs. This discrepancy put in full relief the existing contradictions that exist in all MFIs but that became dramatically salient in the Mexican case. An example of this is the inherent tension that exists between the stated goal of reducing poverty and positively impacting clients and the real constraint of maintaining MFI sustainability through profits. Fourth, given the relatively high market concentration, it is easy to identify market leaders and the most established players who are at the forefront of the market and who set the pace – and the normative example—for other emerging MFIs. For all these reasons, the Mexican case provides an especially fertile ground to analyze how established norms and institutions both constrain actors within a system but also enable –and sometimes drive— them to engage in norm deviance and experimentation which, in turn, end up

[13] MixMarket was created by the UN Conference on Trade and Development (UNCTAD) and is a global, web-based, microfinance information platform. It provides information to sector actors and the public at large on microfinance institutions (MFIs) worldwide, public and private funds that invest in microfinance, MFI networks, raters/external evaluators, advisory firms, and governmental and regulatory agencies. www.mixmarket.org

transforming those same norms. Chapter 5 of this dissertation provides insights into precisely that process by analyzing three leading MFIs that were established in the first wave of MFI emergence and that, by the time of the study in 2004, had both become market leaders and had committed to one of three internationally accepted structures. At the same time, each of them showed significant degrees of divergence *within* their structures in the way in which formal rules were actually *enacted.*

Both of these empirical cases –the emergence of the SME credit market and the evolution of MFIs—give insights into different parts of the process through which institutions are created, enacted, and changed. The Mexican financial sector is a particularly fertile ground to analyze these processes given its historical backwardness and inertia and the different changes it has experienced in the past decade. These change processes are yet to fully unravel and thus present a unique window into a dramatic transformation in the making, allowing us to observe their dynamics as they unfold.

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Chapter 3

The SINAFIN Program: Chronology and Results

Introduction

Small and Medium Enterprises (SMEs) form the bulwark of most developing economies and yet they face significant barriers to growth. One of the most pressing challenges for these firms is their lack of access to efficient financing, and their resulting reliance on expensive trade credit. This was certainly the case –as I showed in Chapter 2—in Mexico before 2001, where the financial sector was largely underdeveloped. Its strongest players –the national banks—did not consider SMEs to be a viable segment, viewed firms as unacceptably risky and not credit-worthy, and were reluctant to provide business credit to SMEs. In fact, national banks did not even possess the organizational capabilities to perform credit analysis. SMEs, for their part, did not hold a much different view on the viability of a credit market. They did not think of themselves as credit-worthy and did not trust banks in general. As a result, they did not consider bank financing as an alternative. Not surprisingly, existing legislation was also not conducive to business financing given its complexity and unpredictability. Four years later, the situation was practically reversed. After investing only $150 million of government funds –a small amount for a government program—close to two hundred thousand SMEs had received more than $4 Billion in bank credit. By 2006, all of the major banks had an area exclusively devoted to SME credit and several considered SMEs as their priority segment. Legislative changes had also been initiated and SMEs were demanding credit at never before seen rates. How could such a small program, launched from the Ministry of the Economy which had relatively little power, stimulate such a widespread change in such a short time? And, what can this tell us about how institutions are changed?

These questions extend well beyond the case of Mexican SMEs. Institutions directly affect human action at the individual, the group, and the organizational levels (Clemens and Cook 1999). While stable by definition, institutions are not exogenous in nature, but social constructions endogenous to human action. It must then be the case that, together with stability, change is intrinsically built into them. Moreover, markets are supported by institutions that, depending on their particular configuration, determine the path that a country will follow in its development (Fligstein 1990; Acemoglu *et al.* 2001, 2002).

Therefore, it is important for theoretical as well as normative reasons to understand how market institutions –such as those that affect SME financing—change so that we may understand how they can be improved (Rodrik 2006). In particular, increasing attention has been recently paid to the study of endogenous institutional change, significantly improving our understanding of its mechanisms (Clemens and Cook 1999; Streeck and Thelen 2005a).

A puzzle emerges, however, from the recognition that individuals –or "institutional entrepreneurs"—play a central role in initiating change (DiMaggio 1988; Beckert 1999; Greif and Laitin 2004). The finding is puzzling because institutions, as was discussed in Chapter 1, bring stability to social life through the convergence of common beliefs, allowing for coordination amongst individuals in uncertain environments (Arrow 1974; Beckert 1999). Thus, one of the important consequences of institutions is to increase predictability by *reducing* alternative courses of action. Conversely, institutional change entails *adding* new courses of action. But if institutions operate through the convergence of actors' beliefs on what are appropriate (and thus expected) courses of action, how can an individual who has been socialized into a set of governing beliefs suddenly abstract herself from them and envision a different possibility (Piore 1995; Battilana 2006)? Moreover, if institutions operate through shared beliefs, changing institutions would entail convincing others of a new possibility, which would require significant resources and organizing capability (DiMaggio 1988). But who could have such a combination of resources and skill (Fligstein 1997)? For example, given how strongly banks tend to socialize their employees (Weeks 2004), how could an individual within a bank envision challenging the belief that SMEs are not a viable segment? And how could she mobilize her organization together with the wider set of players whose participation would be necessary to create a new market?

One possible answer is that only exceptional individuals with unique skill sets can generate institutional change, which would explain why it so seldom happens (e.g. Caro 1982, 1990; Hargadon and Douglas 2001; Munir and Phillips 2005). Cosimo de Medici,

for example, is described as an extraordinary yet enigmatic man, with a remarkable capacity to influence others by strategically veiling his interests, which helps explain the institutional transformation he achieved (Padgett and Ansell 1993). If that were the case, then the transformation of Mexican SME finance would be attributable to the good fortune that such unique individuals happened to be in the right time and place. But there are good reasons to doubt such an account and to allow the possibility that institutional entrepreneurs are not at all rare. First, several other governmental programs, targeting a similar segment, and run by similar government officials had previously existed but had not succeeded –the most recent in 1997. Second, consider traditional business entrepreneurship. Only a small fraction of business entrepreneurs are successful in starting a business, even though many try; and success is not necessarily determined by individual skill (Sørensen and Sorenson 2003). Moreover, both successful and unsuccessful attempts are recognized as equally instructive instances of entrepreneurship. Thus, if we define an institutional entrepreneur as a person who *attempts* to create a change but who is not necessarily successful, then there may be more institutional entrepreneurs than change outcomes would suggest. At the same time, the stability of institutions that derives from shared sets of beliefs would seem to be at odds with the image of a large group of institutional entrepreneurs constantly seeking to change them. The prospect is not implausible once we clarify that it is in fact *public* beliefs that converge in institutionalized settings, while *private* beliefs of many may diverge without being noticed, as they are not externalized (Kuran 1989; Centola *et al.* 2005). The implication is that, at any point in time, there could be many skilled individuals whose private beliefs diverge from institutionalized ones, and who are *potential* institutional entrepreneurs.

The next two chapters analyze the creation of the market for SME credit in Mexico, which highlights how institutional entrepreneurs from different organizations coordinated to purposefully initiate institutional change (DiMaggio 1988; Colomy 1998). The chapters–in particular in Chapter 4— argue that institutional change is not rare because institutional entrepreneurs are scarce. It will show that, in fact, individuals with the ideas,

personal qualities, and actions typically associated with institutional entrepreneurship are quite prevalent. What makes change infrequent, then, is that it entails a sequence of relatively unlikely occurrences, all of which must happen. For an individual to purposefully initiate institutional change, she must first detect an opportunity for change and, once detected, she must be willing to incur the costs (and risks) involved in the creation of new alternatives. In addition, she must be able to initiate the change. That is, she must mobilize enough resources and generate consensus between different groups to engage in experimentation. Finally, she must disseminate positive results to begin the institutionalization of new practices. Only certain positions in the organizational structure, when combined with specific personal capabilities, allow such levels of discretion, resource mobilization, and group spanning.

Chapter 1 of this dissertation highlighted the need to determine not only *who* is an institutional entrepreneur but also *how* it is that she becomes one. That is, under what conditions will a *potential* institutional entrepreneur *actually* turn into one? It also suggested that, to develop such an explanation inductively, we would ideally seek to observe a full set of individuals who are at risk of becoming institutional entrepreneurs when an opportunity arises[1] and follow them through time. Such an effort would lead us to look at institutional change as a sequential –rather than a linear—process and to observe successes *and* failures at each stage. The case of SME financing in Mexico provides a unique research setting to address many of the issues set up on Chapter 1. First, the program was designed from the central government and offered to all major banks to be implemented in all of the Mexican states; but given the structure of the banking sector and the fact that Mexico is a federation, there is significant variation –that is not explained by wider structural factors—both at the bank and at the State level in the results achieved, as was described in Chapter 2. I leverage these sources of variation to isolate the factors that rendered only some efforts successful. Second, while I was not able to observe the change process in its entirety, my close to two years of observation occurred during some of its most dramatic stages, when overall success was far from

[1] See Footnote 7 in Chapter 1.

evident. These semi-retrospective data represent a significant improvement over purely retrospective accounts. Third and related, because most of the actors that began the program and drove its main efforts were still actively involved at the time of the study, I viewed the processes of change at different levels of analysis and I can provide a window into the different –successful and unsuccessful— alternatives that were tried, by different people, to promote change. These unique data demonstrate that successful change requires the combination of an environmental opportunity together with an institutional entrepreneur that can understand it, has the motivation and skill to pursue it, *and* is situated in the right structural position to be successful.

The current chapter (Chapter 3) presents the data and methods I used to analyze the SINAFIN program. It also presents a chronology of its emergence and a description of its results, impacts, and shortcomings as a government program. The following chapter (Chapter 4) explores alternative explanations that could account for the success of SINAFIN, establishes it as an instance of successful institutional entrepreneurship, and delves into the mechanisms that allowed certain individuals in the Mexican context to spark the institutional transformation that led to the creation of the SME credit market.

Data and Methods

The research design leverages the sources of variation that I described above to disentangle the mechanisms of institutional change and the role of agents in them. It does so by taking advantage of the unrestricted access granted by the Ministry of the Economy to several sources of unique qualitative and quantitative data.

In terms of qualitative data, I have performed a series of in-depth, ethnographic interviews and observations at the federal level and across six different states[2] to further explore the details of different change efforts. I have totaled just over two hundred formal, documented, semi-structured interviews and countless other non-documented but

[2] I picked four states as my case studies, choosing two successful and two unsuccessful states. I later decided to visit two additional states (one successful and one unsuccessful) to provide some validation of my findings

relevant informal interviews. Average interview time was one and a half hours, with a minimum of forty-three minutes and a maximum of over three hours. Observation periods with extension agents[3] lasted a full workday with each one of them (I worked with twenty in total). I also made an effort to observe as many client-bank interactions as possible, and I passively participated in five loan-contract signings. Approximate distribution of the semi-structured interviews may be seen in table 1. On top of these interviews, I attended several meetings at the Ministry of the Economy, participated in some of their program discussions, and spent many days working in their offices and analyzing data together with their team. Additionally, I participated in several federal and state-level seminars and symposiums where all the relevant institutional actors gathered, and I have met with several government officials and bank directors to discuss and validate my findings (none of these additional interactions are recorded as interviews).

To select my interviewees, I first interviewed all the federal government officials who were directly responsible for the design and implementation of the SINAFIN at the SE. Through those interviews, I detected the actors from different organizations at the federal level who were either directly involved in the program or had a clear stake in it. To further detect the relevant organizations to consider I attended the SE's "SME Week", and listed the *types* of organizations that attended.[4] With the help of the SE I interviewed individuals from each type of organization, making sure to include both organizations that were active in the program as well as those with a passive role. I later followed the same "organizational map" in each of my state cases.

[3] Extension agents were created by the federal government to act as a bridge and as "translators" between the banks and SMEs. They are hired and trained by State governments and paid by both Federal and State governments on a success fee basis –the activation of a loan being considered a success.
[4] For example, if a particular business association was present, I listed "business associations" as a type of organization affected by the program.

Table 1.- Description of Interviews Carried Out

Level	N	People Covered
Federal	50	- Ministry of the Economy: Current minister and SME sub-minister, all other senior officials responsible for the development and/ or operation of the programs (current and former) - Main national banks: Three interviews in each, with the SME product "owner" (director), its operator, and the relevant credit analysis manager - NAFINSA (development bank): Interviews with all the officials involved in the development and/ or operation of SME programs (current and former). Additionally, one interview with a senior official (COO or SME director) of three other development banks - Other bank intermediaries: One interview at each organization either with the CEO or the director responsible for SME lending, as applicable NGOs (three organizations, six interviews total)
State (4 cases)	120 (30 ea.)	(Typically) - Two-to three officials from the local ministry of the economy (senior and operational) - One or two officials from the state delegation of the federal Ministry of the Economy - Regional directors and/ or regional SME managers for at least three leading banks - At least two branch executives - At least three presidents of local business associations - Four-to-five extension agents - Ten business owners (current loan holders, loan applicants and rejected prospects)
State (2 extra)	30 (15 ea.)	- One or two officials from the local ministry of the economy (senior and operational) - One or two officials from the state delegation of the federal Ministry of the Economy - Regional directors and/ or regional SME managers for at least three leading banks - At least one presidents of local business associations - Two to three extension agents - Five business owners (current loan holders, loan applicants and rejected prospects)

To pick my six state cases, I followed two separate approaches. First, in my round of fifty federal-level interviews I specifically asked all subjects to mention the states where they thought the program had functioned particularly well, as well as those where it had functioned particularly poorly. I later picked the cases that most consistently got picked

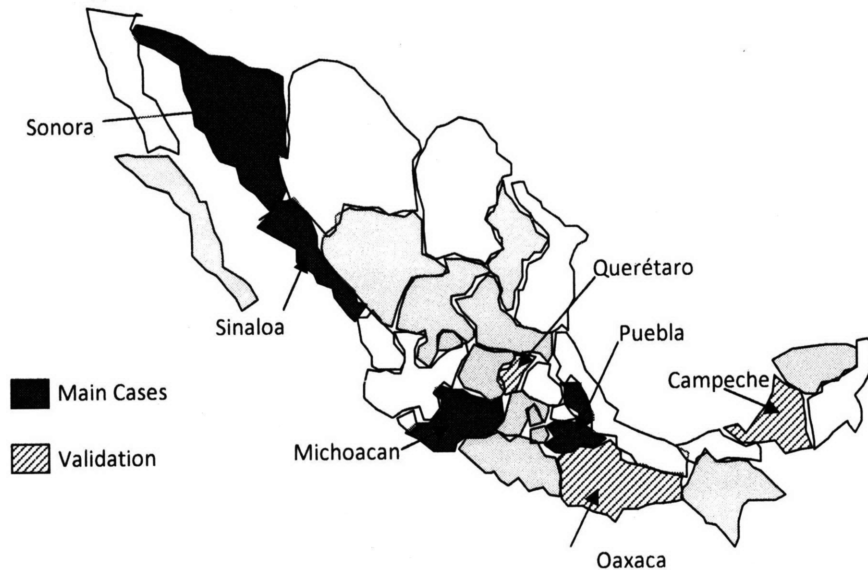
as good (Sinaloa), as bad (Sonora), and as average –with some good and some bad aspects—(Campeche). Second, I analyzed loan placement rates and patterns (see description of quantitative data below) including bank concentration levels, state-level wealth and economic activity, industrial structure, political composition, and geographical location and independently picked cases that both matched different performance levels (good, medium, bad) and that allowed to perform good matches on other structural aspects, to control for as many additional factors as possible such as geographical and political dimensions. Through this second method I picked Michoacán, Puebla, and Querétaro (I also performed some validation work in Oaxaca). The geographic distribution can be better appreciated in figure 1.

In terms of quantitative data, I was granted access to all the records that currently exist on the different aspects of the program, as follows:

1. A registry of all loans granted through the program: Contains information on all the companies that have received loans. This includes firm characteristics (sector, size, location, sales etc.) as well as loan size and use, lending institution, type of guarantee used, whether the guarantee was claimed (i.e., if the loan became delinquent), and other useful information. The database contains around 106,000 separate observations.
2. Registry of the extension agent program: Contains information on all the companies that extension agents have visited, whether the loan was granted or not (if the loan was indeed granted, then the same company will appear in the first database and thus the datasets can be linked), rejection reasons if applicable, and information on a follow-up visit agents must perform six months after their initial visit.
3. Survey of 1,400 firms collected by FUNDES:[5] Gauges the impact on an SME of getting a bank loan. This national survey included companies that have been granted loans (900) and a comparable counterfactual group (500).

[5] FUNDES is an NGO that covers all of Latin America and seeks to promote the development and competitiveness of SMEs in the region through research and lobbying activities.

Fig. 1.- State Case Selection



The Evolution of SINAFIN

The chronic need for financing that Mexican SMEs had suffered, the complete lack of a viable credit market, and the surprising fact that SMEs had never been identified as a political constituency, led Vicente Fox's campaign team during the 2000 presidential election to make them a central element of his campaign. One of Fox's campaign slogans was that his government would be the first to truly "turn to look at the 'changarros'[6]".

Once he was elected, President Fox created a new agency within the Ministry of the Economy: a sub-ministry charged with the broad mandate of generating an integral business promotion policy, which should include specific goals and success metrics. The agency was assigned a budget of $1,800 million pesos[7] for the design and implementation of promotion programs. It is important to note that, relative to the Mexican Federal budget, or to the size of the Mexican SME segment this was a very small budget. At the

[6] Changarro is the Mexican slang word for a very small business, typically a mom and pop store.
[7] Around $150 Million US Dollars

same time, it was the first time that any budget was destined exclusively to the development of SME-specific programs.

In the years that followed, the Ministry of the Economy channeled a total of 1.7 billion pesos of federal funds to several programs, the most important of which was the creation of a system of guarantee funds destined to activate bank lending to SMEs. The amount of credit placed by each peso invested in guarantee funds grew from two in 2002 to more than sixty by 2006. As a result, the money invested in guarantee programs had a strong multiplicative effect, where close to two hundred thousand firms received more than 40 billion pesos in loans by 2006.

The Enterprise Development Plan (PDE)

Given the historical absence of integral policies to promote SMEs in Mexico and the broadness of the received mandate; the Ministry of the Economy (SE) initiated its operations with a broad diagnosis of the situation faced by Mexican SMEs.

To accomplish this, the SE organized a series of roundtable discussions that included academics, business owners, business association representatives, bank managers, development bank officials, and government officials from all levels of government. This consultation lasted several months and was extended to the entire country to identify the central challenges that businesses faced. The main product of this diagnosis was the creation of the Enterprise Development Plan (PDE) which was later incorporated to Fox's National Development Plan (PND). The PDE represented the first time that an integral, federal policy was defined to strengthen SMEs. The PDE reflected the priorities expressed by SMEs across the country, where the lack of access to competitive financing was identified as the largest roadblock to development; followed by the need for training and access to better technology.

In consequence, one of the SE's central priorities was to reactivate SME lending in Mexico: With the virtual disappearance of private credit in Mexico after the 1995 crisis, it had only reached 18.5 percent of GDP by 2003, the lowest level amongst all OECD

countries. Just as the activation of lending became a priority, so did achieving this activation through the existing players in the financial sector:

> "(...) there were already several institutions in Mexico that existed with the sole purpose of promoting financing activity and economic development in the country, but they were not fulfilling their function. It was necessary to reactivate and reorient them. At the same time, the problem was not the lack of a developed or an under-capitalized financial sector. We were convinced that it was existing financial intermediaries –and not the government—that should develop the tools to evaluate, analyze, and finance businesses in Mexico. The government should do no more than fulfill its role as a guide and rector." (SE Manager).

The SE thus defined its frame of action in the coordination and creation of a set of incentives for existing relevant actors, seeking to generate an appropriate climate that would encourage financial intermediaries and existing development banks to participate more actively in SME financing.

While the PDE did not specifically define the activities that the SE would perform, it nevertheless provided a coordinating mechanism between the government and other relevant players, as well as a clear action plan that guided the activities of the SE in the following years. I quote from the report:

> The Enterprise Development Plan 2001-2006 is the axis that articulates policies, programs, and actions that will allow the SE to achieve its national objective of increasing the competitiveness of businesses in the country, in particular that of micro, small and medium firms. The PDE establishes the following:
>
> (...) Financing as a lever for development is an indispensable element in any and all strategies pursued by the Federal Government to boost the competiveness of SMEs. Accordingly, the SE in coordination with state and municipal governments, as well as Mexican development banks will generate an articulated mechanism to bridge the gap between supply and demand of financial resources.
>
> (...) The SE will promote the creation and consolidation of programs between all financial intermediaries to facilitate access to financing for Mexican businesses, in particular for SMEs as a central development strategy in different regions and sectors of the country. This redefinition will require the following actions:
>
> - Analyze and complement all existing programs within the development bank network as well as other government agencies

- Create specific instruments and products to truly address the demands of Mexican SMEs and satisfy their needs. These needs will be defined in conjunction with businesses, business associations that represent diverse regions and sectors, and existing bank and non bank financial intermediaries
- Develop specific incentives for commercial banks and non bank financial intermediaries to encourage them to provide formal financing mechanisms to SMEs with low amount requirements
- Foster the creation of angel investor funds and other risk capital vehicles.

To reactivate financing activities for SMEs, the SE will promote the following action items, around the central idea of fostering a competitive financial system and the creation of guarantee funds:

The Ministry of the Economy will pursue specific action items:

- Foster a new credit culture in the country
- Strengthen existing programs within development banks
- Creation and strengthening of guarantee funds
- Creation and strengthening of funds for specific sectors
- Strengthening of non-bank financial intermediaries
- Foster international cooperation for the financing of SMEs.

To achieve these objectives, the three levels of government will coordinate a stronger relationship between development banks, commercial banks, and non bank financial intermediaries and existing businesses. In this effort, the SE will seek the active participation of business associations and chambers in each region and sector of the country.

The National Guarantee System

Bank Credit to SMEs

Once the SE established the activation of SME financing as its priority, it initiated a new diagnosis process to understand why, even in an environment of increased macroeconomic stability where there was a clear market need, lending to businesses was inexistent. The diagnosis consisted of a set of roundtables with managers from all commercial banks and other financial intermediaries. The process revealed that business credit was failing at several points of the value chain. Commercial banks did not have any credit products that would be attractive to businesses, development banks did not have any programs that could successfully foster lending, and businesses did not trust banks and were removed from the financial sector. A significant part of the breakdown came

from the fact that most commercial banks had an extremely negative perception of the SME segment as uneconomically risky. This perception was fueled by a lack of knowledge of the segment but also by the aftermath of the 1995 financial crisis as well as the poor credit culture that was generated by some previous programs. As I mentioned before, most of the little SME financing that was historically present had been granted through development banks (mostly NAFINSA) as well as state-level funds. The majority of these programs, with few exceptions, had poor results because of their excessive bureaucracy and, in many cases, because they were used as political tools and were run in a clientelistic fashion, which resulted in low recovery levels and the promotion of a poor payment culture.

In addition, due to the 1995 banking crisis together with the banks' sole focus on government and corporate credit, Mexican banks in general lost their ability to perform business credit analysis and many of them lacked the organizational areas required to do so. As a result of this, even in the few cases where a bank agreed to attempt to grant SME loans through previous guarantee programs designed by NAFIN, very few firms were actually able to access a loan due to excessive accounting and financial information requirements, extremely long analysis processes, and unreasonable collateral demands. On the SME side, given the historical lack of business credit and the questionable collection practices followed by the financial sector in the aftermath of the 1995 crisis, most SME owners completely lost their trust in commercial banks and they stopped seeing them as a viable option for their financing needs. With their trust in banks, SMEs also lost their ability to manage a loan application process or an actual bank loan.

Given the distance that existed between financial intermediaries and SMEs, the SE sought to create a new type of guarantee program in conjunction with relevant players that would allow commercial banks to experiment with new credit products for SMEs with a limited level of risk. The idea was that such pilot products would allow banks to test the segment and slowly gain knowledge of it through the gathering of statistical information and the sharpening of risk profiles.

The birth of the SINAFIN

Background

From an organizational perspective, NAFIN and the development bank system was responsible for the activation of SME lending in Mexico. In fact, and as I mentioned above, NAFIN had indeed attempted to develop several guarantee programs to activate SME lending in the past, the latest effort as recently as 1997. This program offered banks a guarantee that oscillated between 50 and 70 percent of lent amounts at a cost of 2.5 to 3 percent of the guaranteed amount.[8] However, even though this guarantee program was an antecedent to existing programs, it achieved poor results and in some cases generated more damage than benefits, as it only increased certain banks' reticence to engage with the SME segment. The central problem with NAFIN's guarantee program was not its conceptualization, as most banks found the idea of such a program interesting. The central problem was found in the program's actual design and implementation.

The guarantee products were designed inside NAFIN, with no serious participation of outside actors. Given NAFIN's recent history –it practically went bankrupt during the 1995 crisis due to a lack of administrative controls that led to questionable lending practices—and the lack of outside participation in the design process, the guarantees were basically inoperable. While it is true that one of the most attractive features of this guarantee was that it did not place any restrictions on the loan product it would support, aspiring banks had to go through an exhaustive due diligence that covered their credit analysis processes and collection practices. In addition, each guaranteed loan that had been authorized by the bank was also analyzed by NAFIN and had to be authorized by it as well, which duplicated processes and considerably lengthened response times:

> "The truth is that the guarantees were designed so we wouldn't have to pay them. Because we had just come out of a banking crisis, we didn't trust the banks' processes, and because we had nearly gone bankrupt as a development bank we had a strong mandate to maintain our capital and have profitable operations. This meant that in order to be even considered for the program, a bank had to go through intense and constant scrutiny by NAFIN. Additionally, in order to qualify for a guarantee, each loan had to fulfill a very complex set of requirements, especially document-wise. Banks were asked

[8] Contracting loan insurance in the international market, by contrast, carries a cost of 0.5%

> to keep a strict record of each of their clients, including a very large list of documents that had to be periodically updated. If a loan became delinquent, NAFIN would cover the loss, but then the bank had to keep that client's and update them every few months, as well as show that it was doing an effort to collect the loan. If a single document was ever missing, or a deadline was not met to the day, the guarantee would be 'rescued' [taken back] and because we had access to the banks' reserve accounts through the Central Bank, we would just deduct them automatically and later inform the bank that the guarantee had been rescued. Worst of all, these contingencies were life-long, which meant that a bank had to keep a record of a delinquent client for good, and if anything was ever missing or lost there was always a risk of having the guarantee rescued. For all practical purposes, the banks couldn't rely on our guarantees and the program represented a cost much more than a benefit, because of the administrative burden it imposed on them." (-NAFIN manager)

The guarantee's high cost, the bureaucracy involved in the system, and the constant threat of "rescue" made the guarantee product flop due to the high administrative costs it imposed on banks while keeping them in a constant state of uncertainty on the validity of the guarantee. In consequence, only one bank (Bank Epsi[9]) managed to test the guarantee with very limited effectiveness while the rest of the banking sector lost the little trust they kept in government agencies and development banks. The result of these failed programs and recurrent crises was a complete breakdown of trust between the banks, the development banks, the federal government, the state governments, and the SMEs. When the new SME team entered the SE, this was their largest barrier to bringing about any change in the system. Not only was there a lack of products for SMEs within the banks, but also SMEs were now lacking credit culture. The banks lost interest in the segment and the processes and information required to even consider launching a product. More importantly, there was a relationship of open confrontation between all the players that needed to come together in order to make an SME financing system work. The whole institutional environment was set against the concept of SME credit.

This notwithstanding, the initial consultation process carried out by the SE coupled with a thorough benchmarking of international best practices concluded that a new guarantee system, backed by the federal government but operated by commercial banks, was a way

[9] For confidentiality reasons, all the banks' names have been changed

to activate the national SME lending market. Financial intermediaries did recognize the lack of financing options for SMEs and the size of the potential market, but they were also aware of their lack of experience with the segment and their need for a mechanism that allowed them to control the downside risk of testing an unknown segment. It is important to note that several alternatives were seriously considered in the design of a new guarantee system, including reciprocal guarantee mechanisms that are prevalent in Europe and in other Latin American countries.[10] Even though such schemes have attractive features like the socialization of the cost of the guarantee, the ability to attract private resources, and their self-regulating nature; they were deemed inappropriate for the Mexican market given its state of backwardness. First, such reciprocal guarantee schemes hinge on the existence of solid business associations that can manage them, which are not prevalent in Mexico. Second, they start from the premise of an existing, well functioning financial sector that is already lending on a regular basis. The goal of such guarantee systems is to facilitate the access to loans for firms that lack collateral or are otherwise excluded from borrowing. Mexico was at a much less developed starting point, as banks were not lending regularly.

The SE, therefore, had to first convince banks to negotiate on guarantee system to promote SME lending. Because of the fracture that had occurred between development banks and commercial banks, the SE had to start by rebuilding a relationship with the banking sector. The SE was able to build on a renewed legitimacy to call for a new process of business-government collaboration. First, the SME team was a new agency within the SE. Second, the Fox administration was the first democratically elected government in more than seventy years. Third, it came from a right-wing party. The SE thus initiated the collaboration process by seeking to rebuild the broken ties between development and commercial banks and establishing a new, collaborative relationship where they acted as coordinators and mediators.

[10] In reciprocal guarantee systems, firms group together and become guarantors of each others' loans by placing a cash deposit equivalent to a fraction of their guaranteed amount in an escrow account. Banks can then access the escrow account in case of a loan default.

As a new agency, the SME team of the SE faced an additional challenge. They had been granted a budget of 1.8 billion pesos to execute SME promotion programs. Having these resources, however, presented a problem as well as a solution. As a government agency, once you are granted federal funds, you are obligated to use them on a yearly basis, and the SME office had yet to define what they would use their budget for. More importantly, they lacked the infrastructure, the people, or the experience to manage those funds. This means that the SME office needed to accomplish two things at the same time: they needed to define the strategy to reactivate SME credit, while at the same time using their yearly budget. This challenge prompted the SE team to approach state governments at the same time that they established negotiations with commercial banks. State governments already had the administrative infrastructure (and in many cases the local development fund structures) to effectively dispose of the SME budget. In the words of the director in charge of program operations at the SE:

> "We knew that the funds we received from the federation would be relatively scarce to run our programs, and we knew we didn't have the infrastructure to manage those funds, so we had to establish strong alliances with the state governments both to pool federal and state resources and to use the state government structures to operate the programs. As soon as we had the PDE, we spent the next six months (the first half of 2002) signing agreements with all the state governments and then, as soon as we got the initial money from the Ministry of Finance, which amounted to around $150M, we distributed funds to local state structures."

This initial disbursement of funds accomplished several goals. First, it allowed the SE to forge (in many cases previously inexistent) working relationship with state governments, where it was established that the SE was taking SME development seriously and would now lead the efforts around it. Second, it sparked the interest of state governments in the design of guarantee programs to promote SME lending. Third, for the most part it did allow the SE to use its budget in a relatively controlled manner. At the same time, while the strategy proved to be effective in using the 2002 budget, it was ineffective in achieving actual results. Without a clear-cut strategy and without a set of clear rules and controls, the state governments' responses were as varied as their geographies. Even though the money was earmarked as a 'guarantee fund,' some states (the "better" ones) used it to simply strengthen and complement their already existing SME-support

structures (like the SME fund in Jalisco –FOJAL), others, like Campeche, made attempts at lending money directly to SMEs (with questionable results), while still others simply spent the money on political campaigns or on buying political favors. It became patently clear, therefore, that the programs had to both be led by the federal government to the extent possible and seek the support of the state governments on the SE's terms.

The initial experience with the states had an additional benefit. Because the budget was assigned to promote guarantee funds but the states were left with absolute freedom to choose how to do it, the country became a de facto laboratory where tens of different guarantee program experiments were attempted. As the SE moved forward with the design of the national program, these early experiences proved invaluable to detect best practices. The state governments that achieved the best results such as Sinaloa, Michoacán, and Jalisco were invited as active participants in the design of the national program, and they added significant value to the process.

First Bank Products

Following the SE's invitation to participate in a new guarantee program, several bank managers were enthusiastic about creating new SME credit products. At the same time, there was enormous institutional resistance to change. After the 1995 crisis, banks had become increasingly reticent to lend, especially to SMEs. To maintain profitability, the banks focused on lending to the government and charging high commissions for bank services. Accordingly, their organizational structures were entirely focused on the attraction of new accounts and business lending was far removed from their capabilities. As a result, when the SE launched the open invitation to all banks to participate in the new guarantee system, only three commercial banks and one development bank agreed to participate. Of those four banks, one insisted on working on the improvement of existing NAFIN guarantees (Bank Epsi), and only three were willing to design a new guarantee system.

Extensive negotiations began with these three banks, with important differences between them: Since the SE had decided to work together with NAFIN to the extent possible; the

original idea was to have three-party negotiations including each bank, NAFIN, and the SE. However, Bank Alfa expressed a large interest in working with the SE and offered its organizational support to generate innovative ideas, but at the same time conditioned the participation on not having to work with NAFIN.

> "(...) we simply didn't want anything to do with them. Our previous experiences had been so terrible that there was an organizational mandate to avoid any contact." (Alfa manager).

One of the most important innovations that came out of those initial consultations with the banks was the idea of changing the SME credit analysis process from traditional (project-based) analysis to parametric credit scoring, which was one of the main factors that allowed for the quick deployment of mass credit to SMEs:

> "One of the more persistent questions I posed to the banks, was how it could be possible that they were literally throwing credit cards and other consumer credit products at their customers, while at the same time restricting credit to those same customers' businesses. Part of the answer was that the type of credit was different and the analysis methodology was not the same, as consumer credit used parametric analysis. Because the banks had been away from SME credit for such a long time, they had not developed a set of parametric models for SMEs and they therefore had to do traditional analysis. I can't remember exactly at what point in those conversations we came up with the idea of using the parametric models they had already developed for consumer credit to run the analyses on the business owners and use them as a proxy for the business." (SE official).

The first two agreements that came through were two small guarantee programs with Bank Alfa and Bank Beta, which were specifically designed as pilot tests. With Bank Beta (a small development bank), the idea was to lend money to SMEs that were focused on exporting. The program consisted of a guarantee fund to cover $70M (less than US$7M) in loans. During the negotiations with Beta, the bank mentioned that they had been running some simulations and they expected their losses to be around 5-7 percent of the portfolio, so they asked the SE to back them on those expected losses. Given that the SE team did not have a financial background; this was a new concept which was different from traditional guarantee systems. For this test, they placed $5M in an escrow account within Beta and launched the program. As it later turned out, this pilot program was a disaster for Beta, because they learned that their parametric credit analysis models were

wrongly calibrated, so they ended up assuming a much larger risk than they had originally estimated and had to stop the program mid-way. Unsuccessful as it was, however, it achieved the important purpose of teaching the SE about expected losses and their estimation through simulation and parametric models, which later became a central part of the guarantee program.

With Alfa, the initial program was quite different. They were not organizationally ready to start an aggressive SME lending program, as the SME segment was still internally perceived as too risky. They therefore proposed a program destined to "bankarize" SMEs and to start testing the segment. The idea was to place POS machines in previously unattended businesses. Alfa would provide the machines and would offer the businesses a loan to buy a PC to run the software. The SE would guarantee the POS machines if the businesses stopped paying the monthly fees, or if the machine was broken or stolen. The SE also put forth the idea learned from the Beta program of guaranteeing some loans on a first-loss program, but Alfa refused. It is important to note that the SE tried to approach NAFIN with the program idea –even though Alfa didn't want to work with them—to try and build a bridge between the two organizations. NAFIN did not quite understand the program or the SE's involvement in it and did not agree to participate. Because the SE was forbidden by law to directly manage guarantee funds, they decided to contact FUNDES, an NGO that specializes in Latin American SMEs, as the trust fund manager. FUNDES originally built a relationship with the SE team during the roundtables of the PDE, and they agreed to find a way to establish and manage the appropriate trust funds.

Like the Beta pilot, this initial program was unsuccessful, especially because it was far removed from the goal of bringing financing to SMEs, but the SE knew and expected this:

> "I hated the POS program. It was so far from what we really wanted to do that I saw it as a waste of time and money. We were basically giving money away to Alfa so they would place their POS machines at no risk, and we were achieving zero in activating credit. (The General Director for SMEs) understood where I was coming from, but he explained that we had to find a way in to the banks, even if it was through the back door, and the POS program was exactly that. Time ended up proving him right." (SE Manager).

For the Alfa managers, however, the POS program was not only about testing the SME segment:

> "When the SE approached us and offered to work with us, it all sounded very well, but given our previous experiences with the government and with NAFIN we didn't know if we could trust them. We saw the POS program as a very low-risk way of "testing the waters." When the POS program began and the SE immediately created the trust fund and they repaid all our lost machines on time, we realized they really meant business, and we opened up much more after that. It was a very important step from the beginning, when the word inside the bank was that we would meet with them and work with them, but we just wouldn't find a way to make it all work."

Midway through the POS program, the Alfa manager approached the SE and asked to halt it because of its poor results ("We realized that we couldn't force something on SMEs if they didn't demand it"). More importantly, the program had allowed them to gather more information on SMEs and given them time to think about the first-loss guarantee. They offered to use the unutilized portion of the POS program funds to start a pilot guarantee project, under the first-loss scheme, to give out 1,000 loans to SMEs. Because the trust fund was being managed by FUNDES and because NAFIN was extremely critical of the first-losses product, the SE decided to run the pilot with FUNDES as manager again. NAFIN was not happy:

> "That really pissed us off. FUNDES is not a development bank, they don't have the tools to do any credit analysis, they can't really assess the risk of the programs, and they don't really supervise what the banks are doing. They basically give the banks a bunch of free money in exchange for a number of affected SMEs… it is free money, we simply hate it."

In parallel, negotiations advanced with Delta, who did agree to include NAFIN in the program. The basic negotiations started with the SE and Delta agreeing that they needed NAFIN, but at the same time Delta demanded that the guarantees be made cheaper and simpler. They were particularly concerned about the contingency issues, and they wanted to reduce the price of the guarantee, which traditionally had been 2.5% of the guaranteed amount. As explained by a Delta manager:

> "We had been trying to figure out a way to attack the SME segment, because we knew it was completely unattended. It was really hard for us, partly because the bank had an institutional reticence towards the segment, which it perceived as too risky. When the SE

> approached us with the idea of backing our loans with a guarantee, we saw it as the perfect opportunity to test the segment without incurring too much risk, and it gave the commercial areas an argument against the credit areas who didn't want to take the risks. We needed to know, however, that NAFIN would change its norms significantly, otherwise it simply was not worth it for us." (Adrian, Delta Manager).

NAFIN's initial reaction was negative, because they were defensive about increasing the flexibility in their controls. The breaking point came when Delta offered to follow any credit conditions set by the SE in terms of loan characteristics (collateral requirements, etc.) and would commit to a resource multiplication of 15X (for every peso invested by the SE, Delta would place 15 in loans) in exchange for a loosening of NAFIN's conditions. (The sub minister) jumped at the opportunity and made several announcements indicating Delta's commitment, which created a lot of political pressure for NAFIN to continue the negotiations. The set of meetings that followed were very intense because NAFIN, especially its credit area, was not willing to loosen the contingencies. The negotiations were so rough that at several points the two parties (Delta and NAFIN) got up from the table stating that they would never work together again. Usually the breaking points arose from a relatively small detail in NAFIN's operating norms. In fact, a significant amount of the institutional resistance encountered in the creation of SINAFIN came from NAFIN's resistance to change:

> "When we got involved with the SINAFIN, and for the first two years, all I heard during our internal meetings was that we could not do X or Y because it ran against the regulations. This was my first job at a public agency, so I imagined that those regulations were determined by law. In one meeting I got so frustrated with the amount of resistance that I stopped and asked, 'who comes up with these regulations, anyway?' My staff's answer practically gave me a heart attack: 'Oh, we do!'" (NAFIN, Manager)

In the situations where NAFIN's reticence created tension during negotiations, the SE's role was always to bring them back to the table:

> "The negotiations were stopped at several points, and our role was to bring them back together. We always had to act as the "nice problem-fixer" which entailed approaching both parties with a conciliatory vision, offering middle grounds, avoiding the sore spots, and sometimes not presenting the full truth but a milder version of the opposing party's views." (Javier, SE)

At the end of the day, however, what pushed NAFIN to become more flexible was the fact that the SE was clearly focused on getting the guarantee products through, and it started to create a competition for NAFIN:

> "Two things marked the turning point for NAFIN. The first was that we started distributing funds directly to Beta, to FUNDES, to some state funds; creating alternative guarantee products. When NAFIN reacted and asked us why we were distributing money directly when that was their job, we simply responded that we wouldn't have to do it if they did their job properly. They felt the pressure of potential competition. Additionally, Fox had a clear mandate to support the SMEs, and he had hinted several times that, given that NAFIN was not really fulfilling their mandate, it could possibly make sense to dissolve the bank and channel its budget elsewhere. The dissolution ghost hung over their heads for quite a while." (SE manager).

The negotiations ended up succeeding in creating a new NAFIN guarantee that would cover between 75% and 85% of each granted loan, but functioned in a simplified manner, where the bank approved loan applications and NAFIN only reviewed the exercised guarantees (defaulted loans). Additionally, they agreed on a much reduced contingency and much reduced prices. This guarantee was an important improvement over NAFIN's original guarantee product and evolved in parallel to the alternative, first-losses product.

The SE's priority during this initial stage of the program was to allow the banks to approach a segment that they knew little about and considered to be of high risk. The basic idea was to activate lending in any shape or form. Accordingly, these three initial attempts did not place any restrictions on the banks in terms of product characteristics or credit analysis processes. The only requirement was that the government guarantee would substitute other forms of collateral. As a result, these initial products were an important antecedent to the creation of a new market, but they did not operate well. The main reason for the lack of results was that banks were still wary of the segment and demanded an impossible array of requisites from SMEs to grant them a loan. Coupled with the SMEs' natural aversion of banks, the products registered very low demand.

The Birth of Extension Agents

That initial period of consultation and negotiation with the banks generated a third innovation. The SE, through their training and consulting programs for SMEs, had perceived a strong need among these businesses for somebody to help them through the credit application process:

> "While the banks had completely stopped giving credit, they lost all their credit analysis capabilities and expertise, but the businesses lost that capability as well, they had serious trouble putting together their credit applications, which in those times were quite complex." (SE Manager).

In one of the conversations with Bank Gamma, who was running its own pilot program on SME lending using the old NAFIN guarantee, the bank talked about how difficult it was for them to get to SMEs and convince them that loans were now within their reach. Gamma was also having trouble with prospects because credit applications were typically poorly compiled. During that meeting, a Gamma manager who had worked in agricultural finance programs recounted his (positive) experience with extension agents, who were individuals hired to act as "bridges" between the bank and rural workers and help in the loan application process. They therefore decided to launch a pilot program, where the SE would give the bank some funds to train and develop a force of independent (albeit exclusive to the bank) extension agents who would be paid, like agricultural extension agents, on commission for every successful transaction; they would act as bridges between the bank and the SMEs and would advise the latter on their financial needs and on the application process.

Change of Guard and the Second Generation of Guarantees

As these three initial agreements were reaching fruition, the SME administration within the SE changed, as the minister and sub minister were requested by the president to move to other government areas. The team that came in was quite different, since they had much more of a financial background, whereas the original team members mostly had entrepreneurial backgrounds. It is interesting to note that several of the entering officials had strong previous ties with NAFIN in the past, and a few of them had worked there for many years.

Of the four programs that were being tested (Alfa in first losses, Delta in simplified guarantees, Epsi with traditional guarantees, and Gamma with extension agents) the Alfa program was showing the best results, given the high resource multiplication (twenty pesos in loans for every peso invested in guarantees) and the quick attainment of the proposed milestones. The next best results were attained by Delta, who was placing loans and practically meeting its goals but whose product was apparently not as well designed as Alfa's. The Gamma program started advancing well, but during that time it was acquired by a foreign bank, so all emerging programs were halted and the SME lending and extension agent programs were put on hold. Epsi was slowly prodding along, using the traditional NAFIN guarantee with modest results and also showing interest in extension agent programs.

After closing all the negotiations left open by their predecessors, the entering team ran a quick diagnosis of the situation and recognized a set of challenges:

- While the set of pilot programs and experiments had succeeded in re-establishing relationships with the financial sector and the development banks, as well as in testing different options and programs, what the SE really had was a set of non-integrated things happening at the same time. The first challenge was to gather all the lessons from the experiences and integrate them all into a systemic view
- The initial programs had shown promising results, but they were not moving fast enough. They needed to bring in more banks to the programs (only two banks were lending aggressively to SMEs) and they needed to support other specialized intermediaries to address specific segments
- The participation of the state governments in the programs was not yet well defined
- Part of the reason why the loans were not moving more quickly was that bank requirements were still too cumbersome for most SMEs, so they needed to achieve further simplification in their products.

On top of these operational challenges, they had to face strong political challenges: When they signed the first-loss program agreement with Alfa and FUNDES, NAFIN reacted aggressively. They saw FUNDES as a significant threat because the guarantee product

was much simpler (too simple and unregulated, in their eyes) and, more importantly, it had no cost to the bank as FUNDES recovered its operating costs through the trust fund's financial returns. It represented a large political embarrassment for NAFIN who was supposed to be responsible for SME development in Mexico, and it took control of the system away from them. NAFIN therefore lobbied the federal government to remove the SME team from the SE and, when that was not accepted, to change federal budget allocation rules so only federal development banks could manage trust funds related to guarantees.

Birth of the SME fund

The team ran a set of internal meetings and set up the operational rules for the institutional mechanism to manage all of the SE's budget for SMEs: the "Fondo PyME" (SME Fund). It was the first time that a truly systemic view was proposed, and several changes to the programs were made as a result. An example of these changes was a radical change in the extension agent program. The original version of the program hinged on having bank-specific agents, and they decided instead to generate a force of multi-bank, multi-product agents that could advise SMEs not only on how to put together an application, but also on which financial product was best suited for them out of the different options available to them.

The team also redefined the SINAFIN following a systemic view, based on four pillars: a guarantee system; interaction with financial intermediaries and other credit distribution channels; development of innovative financial options for SMEs including bank credit, seed and risk capital; and extension agents to serve as bridges between clients and financial intermediaries. While this view didn't add any new elements to the programs the SE was already implementing, it did create a structure with clear operational rules and procedures and it provided a clear strategy going forward.

As part of their strategy for SME credit, the SE realized that, although they needed to have more financial intermediaries within the program, they couldn't really force banks to participate or improve their product offering. What they could do, however, was design

the guarantees in a way that would entice them to both join the program and effect certain changes in their products in the process.

The Second Generation of Guarantees

An important part of bringing in more banks and intermediaries to the program to improve the guarantee products with the knowledge acquired through the first experiments. The NAFIN product still had several problems, especially around the audit process that NAFIN performed on the banks, as well as the guarantee collection process which was too cumbersome. The cost of the guarantee was also still an issue, especially when compared to the FUNDES first-losses product. As the SE tried to recruit more banks, several –including Delta, which had so far operated with NAFIN—had heard about the Alfa experience with FUNDES and were interested in working through that program. It is important to remember, however, that NAFIN had lobbied for a change in the regulation to preclude FUNDES from operating a guarantee fund. As the then general director of SME development at the SE recalls:

> "NAFIN had tried to block the FUNDES product. At the same time, we really wanted to work with NAFIN, because it was clear that they were the most appropriate channel and had the best infrastructure to operate our programs, but they were just not willing to change their position. (…) In the negotiations to bring the FUNDES operation to NAFIN, they did not want to operate through first losses –even though the banks loved the product—and they weren't willing to lower any of their prices or improve their processes. It was like trying to negotiate with a wall. After several attempts and much frustration, I took the decision to bypass the new regulation and keep the first-losses product in FUNDES. It was a very tough decision, but we had found a small loophole in the regulation and when I told my boss (the sub minister), he said he could not go on record for making the decision but he would support me when the shit hit the fan" (SE manager).

NAFIN didn't like the first losses program because they believed it wouldn't encourage banks to lend to firms that they weren't already comfortable lending to. NAFIN also believed the program was not symmetric, as the banks didn't have to pay for the guarantee but were being covered for 100 percent of their expected downside risk:

> "We felt like they were giving money away to banks. Banks have a very thorough ROE analysis on all their operations. For a bank to agree to a 5 percent coverage on first losses, they must already know the client portfolio very well, they must be thinking about a

> closed portfolio that they would probably lend to anyway, so it was a gift to the bank. However, the SE was very firm in their position and so were we. It became impossible to negotiate." (NAFIN manager).

The SE had a different take on it. Their priority at that point was to get the banks to lend to SMEs in a massive way, regardless of whether those clients could hypothetically find a loan elsewhere. They wanted the banks to have aggressive penetration strategies, and the first losses product was the best way to do it, because it was simple, it asked no questions about the banks' processes, and it was very transparent. In those agreements, at the same time, the SE for the first time demanded some product specificities in return, as well as more aggressive loan placement commitments. The bank products had to be simplified, loan approvals had to be performed in less than ten days, there would be no collateral, and the credit analysis would be performed through parametric analysis to speed the process. When these three banks signed the first-losses agreement, the program really took off. NAFIN, on the other hand, kept its modified guarantee product but by then only Epsi that was using it.

It is important to remember that, as I mentioned before, part of the reason why the loan market had not taken off was a strong reticence from the banks' credit areas. Banks were still mostly ignorant about the SME segment and they lacked the proper tools to calculate risks appropriately. At the same time, there remained an open distrust of traditional guarantee products that were perceived as inefficient and unreliable. The first-loss guarantee product allowed commercial managers within the banks to justify a mass opening of credit products by "testing" the segment more aggressively while recovering the totality of initial losses. Should default rates rise beyond acceptable levels, they could always stop the experiments. At the same time, first loss guarantees allowed for a transparent and efficient operation. It was understood that the banks were taking a significant part of the risk and it was therefore not necessary to supervise their processes or each of their approved loans as closely as NAFIN had traditionally done.

As the first losses product took off and started showing impressive results, and as other banks and intermediaries expressed their interest, NAFIN had no choice but to accept that their strategy was mistaken:

> "We were really pissed off when the large FUNDES deal came out. We were suddenly left out. We realized we should have been more open to negotiate and suddenly started to see a lot of promotion of a new program for SMEs without NAFIN. The SE and this 'little new bank' (FUNDES) were taking all the credit. (...) We realized that it was one of those 'not good with them, much worse without them' situations. The SE was now negotiating directly with the banks and we were not a part of the process anymore. ANYTHING was better than not being part of that process, and if we didn't think they were doing things in the best way, it was all the more reason to be a part of it and help them improve it." (NAFIN manager).

As traumatic an experience as the FUNDES deal was to NAFIN, it proved to be very useful internally, as one of the commercial directors explained:

> "We had no choice but to agree with the SE and come in with similar conditions as FUNDES, which is what the commercial area of NAFIN had been requesting for months. I told our CEO that we could either let the FUNDES deal continue and lose our competitiveness in the market, or fix things quickly internally to become and remain competitive. (...) FUNDES allowed me to present the case for internal improvement as one in which there was no way out but to react. I am pretty confident that, as much as I hate to say it, we would simply not have changed had it not been for the inclusion of FUNDES." (NAFIN Manager).

Another important part of this second generation of guarantees was the re-inclusion of state governments in the process. Because the SME funds had been centralized again, all the programs were now run through the large banks that had national coverage rather than directly through the state governments. But the latter were still important for three reasons. The first is that they could greatly help in the promotion and diffusion of the programs in their states, as they had much closer contact with local businesses. The second is that in the new extension agent program the state governments were responsible for hiring, training, and supervising extension agents and for covering half of their commission payments. The federal government, in turn, was responsible for developing a standardized certification process and the remaining half of the payments. The program was voluntary though, since it required the state to invest money in it. The third is that,

because the funds available for guarantee programs were relatively scarce in relation to the dimension of the SME universe, the SE needed to find other alternative sources of funds, and asking the state governments to voluntarily participate in the program by investing additional resources was a way to both increase the fund's size and to strengthen the state government's commitment to the local implementation of the program.

After a long process of visiting all the states and lobbying with them, the SE team convinced around 20 states (out of Mexico's 32) to voluntarily invest money in the guarantee fund and in the extension agent program. This achievement is particularly impressive in light of the fact that, should a state government invest funds in the guarantee program, it had no way to ensure that the banks would increase their participation in that particular state, so economically, there was really no incentive to invest in the guarantee system.

The Third Generation of Guarantees: Auctions and non-Bank Intermediaries

As the first-loss product started generating results and NAFIN drastically changed its position to one of openness and willingness to work, the SE began to work on a new guarantee strategy. Due to resource constraints, they were constantly seeking ways to increase the returns on their investment. In an international seminar, one of the SE officials heard that, in Chile, guarantee funds were auctioned among the banks. Even though the Chilean system is completely different from the Mexican one, the concept of an auction stuck: it was a way to further instigate competition among the banks and ensure a more efficient allocation of funds. At the same time, the idea of an auction provided a good avenue for reconciliation with NAFIN. After negotiating hard on the conditions of a new generation of guarantees, NAFIN agreed to streamline its processes and reduce its fees considerably. In return, the SE decided to ask NAFIN to design, promote, and run the auctions:

> "We wanted to give NAFIN a feeling of ownership over the product and an incentive to really make things work and stop blocking initiatives. If it was their ass on the line, they would do it right. We didn't care about who got the most recognition, we just wanted to

> start working as a team again. (…) We always preferred the idea of working with them, and we all knew that we lost more than we gained by avoiding them. They have the mandate, the infrastructure, the know-how, and the institutional backing to do a better job than anyone else. What they didn't have before–and we managed to create in them—was the motivation to try out new things and improve internally." (SE Manager).

Apart from being the mechanism through which trust was again built between NAFIN and the SE, auctions have also been quite successful, as practically all the large commercial banks have participated –albeit with varying levels of enthusiasm. As a result, resource multiplication levels have increased from 20X (coverage of 5 percent of first losses) to around 45X, and there is now increased competition between the banks for the SME segment, which at least two of the largest banks (Delta and Gamma) have identified as their priority moving forward.

On the other hand, other guarantee products have also arisen. The first loss product, while ideal for large, well capitalized banks, is not good attractive for smaller banks. The main drawback has to do with the capital reserves that banks have to create to back their loans. A first loss guarantee has a much smaller impact on a bank's capital reserves than, for example, an 85 percent guarantee on every loan. Even though the latter guarantee may be much more expensive for a bank (as a reminder, it costs around 2 percent) it allows the bank to liberate most of its reserves, which is very attractive for an emerging, capital-constrained bank. What has therefore happened is that both the first loss and the streamlined NAFIN guarantee have become quite popular with different sets of banks. Large banks prefer the first loss product because it allows them to better predict the cost of the guarantee and it still mitigates their risk; smaller, capital constrained banks prefer to work with the traditional guarantee because it allows them to release more of their reserves for productive investments.

Another set of initiatives that the SE has created are those to support non-bank financial intermediaries. These are small financial organizations that specialize in lending to particular sectors or segments of the population who have specific needs or are not served by banks. Being much smaller, these intermediaries are typically more capital

constrained, and the SE has developed some guarantee products to help them secure financing lines.

Current State of the Programs and Next Steps

By all measures, the program has been remarkably successful. There are now more than 25 financial products for SMEs, with loans ranging from $50,000 (about US$4,000) to $10M. More than 200,000 loans have been granted and, more importantly, a competitive dynamic has been developed in the market. There are some large (and small) banks that have defined the SME sector as their priority moving forward, like Gamma; but even banks that openly admit that are not truly interested in the SME credit segment have had to develop relatively competitive credit products for SMEs. In these latter cases, the motivation has been to keep their SME clients' accounts and their use of other products like credit cards, payroll solutions, and checking accounts. Whatever their motivation, all banks in Mexico now have relatively competitive SME credit products and are offering them on the open market. In addition, a critical mass has now been developed within most banks, such that they are regaining their knowledge of the segment, and new parametric models are being created to better measure the segment's risk (which has proven to be lower than originally expected). Most banks agree that they no longer need the guarantees to lend to the segment (but they will not complain if they are still offered). New non-bank financial intermediaries are also being created to fill the gaps that the banks are not well suited to address, like sectors with specialized needs or in complicated geographies.

The most valuable impact of the SE's effort, however, has been a drastic change in the institutional structure of the financial system. It has been transformed from a set of isolated, disputing players to a system where there is cooperation and integration, even between competing banks who now share incredible amounts of information.

It is important to highlight that it would be hard to imagine any of the SINAFIN's impacts without the increased macroeconomic stability that Mexico has experienced in the last two presidential administrations. After the banking crisis and in large part through

foreign investment, commercial banks cleaned up their balance sheets, strengthened their capital structures, and built up stronger capital reserves. Additionally, there were several legal reforms to improve corporate governance and to increase the supervisory capabilities of the National Banking and Exchange Commission (CNBV[11]). In parallel and partly as a result of the increased credit activity, a new law on guarantees and collateral was passed in late 2007 to reduce the cost of loan recuperation. This new law grants financial intermediaries increased security in the recuperation of collateral after a default. In addition, a new Savings and Popular Credit law was passed to establish new, simplified legal forms for financial intermediaries.

Other measures that will surely help in the modernization of the sector include the Law of Credit Information Societies, which allows individuals to access their credit information easily and without cost, also passed in 2007. Also, a new Law for the Transparency and Increased Competition in Guaranteed Credit promotes increased transparency so potential clients can more easily compare between different loan products. Finally, the Law for the Protection and Defense of Financial Services Users provides more options to facilitate restructuring processes.

Moving forward, there are two things that are considered to be priorities. The first and more interesting is that, even though the program has achieved an important critical mass as well as the participation of the entire financial sector and development banks; and even though the internal processes of these players together with relationships between them have become institutionalized; the federal system of guarantees is yet to be officially regulated. When the programs were born and the SME fund was created, they were set up in such a way that government officials could keep full discretion over the funds in order to negotiate freely with the different players and react quickly to arising needs. This means that the federal resources that feed the guarantee system on a yearly basis are at the administrative discretion of the SE (or the ministry of the treasury should it decide to cut the program off). This is not likely to happen, since a great deal of inertia and

[11] Comision Nacional Bancaria y de Valores

commitment has been generated both within the governmental structure and the entire financial sector, but most players consider it a priority to somehow regulate the entire system so that a yearly budget is guaranteed to keep the program growing. Interestingly, most players believe that it is important for the SE to retain control and discretion over the funds, so they can continue their role as drivers of innovation and mediators between the parts. At the same time, however, intermediaries feel like it is time to "legalize" the programs so there is more certainty on their future.

The second is that, given that the guarantees have fulfilled their first goal of activating credit to the segment, it is time to redefine the guarantees to cover segments that still find it hard to find loans, either because the banks consider them to be riskier or because they have specialized needs. These segments include construction companies, private medical practices, shoe manufacturers, among others. In that sense, a new generation of guarantees is likely to emerge, one that shifts the focus from fostering general, massive lending to one that focuses on specialized, sector-specific lending. Additional improvements are also required so that state governments that decide to invest in the program have the ability to determine the program's specific priorities for their state in terms of intermediaries that need to be encouraged or sectors that need to be promoted.

Broader Organizational Impact

The guarantees offered by the SE were undoubtedly an indispensable starting point for the changes that occurred in the Mexican financial sector. The SE played a critical role in coordinating efforts between all the relevant actors and mediating between them to spark broad institutional changes. That said, the creation of new SME credit products required drastic organizational changes for all participating banks. In the creation of an SME market in Mexico, enthusiastic bank managers depended heavily on the SE's guarantee products to legitimize and facilitate their internal change efforts. At the same time, the SE depended heavily on those managers to generate the organizational changes necessary for banks to manage new loan products. Moreover, both the SE and the bank managers depended on the efforts of other organizations, such as business associations and state governments, to help shift the SME's views on bank credit. In that sense, it would be

impossible to think of the broad institutional change that the creation of an SME credit market implied without the drastic organizational changes that banks endured. Conversely, given the strong organizational reticence towards SME lending, it would have been impossible for managers within banks to enact those organizational changes without a broader institutional change.

The Mexican banking sector is composed of roughly thirty commercial banks and seven development banks. The five largest banks are owned by foreign banks. Mexican banks are ranked as the third most profitable in the world in terms of return on assets (for several of the large transnational banks with a Mexican presence, Mexico is their most profitable operation). Such levels of profitability have traditionally derived from high service fees, government lending and, more recently, from consumer credit. Accordingly, the banks' organizational structures reflected these trends with large branch networks focused on attracting deposits and placing consumer credit, large corporate credit areas, and inexistent business credit areas. At the same time, once several banks began testing the SME segment, they quickly realized that SMEs have very specific needs in terms of product characteristics, response times, and customer service that could not be satisfied by existing structures. As these banks generated organizational pilots to test the viability of the segment, they became convinced of its profitability and engaged in deeper organizational changes.

This co-evolution of institutions and organizations has initiated a new competitive dynamic within the Mexican market. As competition for SMEs increases, more and more banks are reassessing their SME strategy and are transforming their organizations accordingly. Today, every bank in Mexico has an SME-specific area within its organization dedicated to the design, development, and management of SME products. Most of them also have created new credit analysis areas that specialize in business credit and have transformed their internal incentive structures to ensure that branch executives place SME products. All of these organizational transformations are an important step in

bridging the gap between banks and SMEs, who are gradually opening up to the idea of trusting banks again.

Results and Impact of the SINAFIN

Evolution of Credit Markets

Guarantee products seek to increase credit market depth. Such depth can be increased in one of two ways: by granting access to loans to firms that have been historically excluded from credit markets or by allowing firms that already have loans to increase their amounts. The central bank of Chile, a pioneer in Latin American guarantee systems, has respectively named these two effects "type one" and "type two" additionality.

Table 2.- SINAFIN Loans

	Number of Loans	% Default**	Average Loan+
Total SINAFIN	113,455	2.8%	266,143
POS Pilot	6,969	25.8%	3,000*
Total without POS	106,486	1.3%	282,419

* There are several observations that are coded as POS loans but are clearly miscoded. They were also dropped.
** Number loans that have been collected as guarantees as a percentage of total.
+ This refers to the actual amount that firms have used, not the approved amount.

The Mexican guarantee program was not an exception in its aim to deepen the credit market. It was, however, different in its starting point. In Mexico, as opposed to other Latin American countries, no firms had access to credit regardless of their financial viability or their credit worthiness according to traditional standards. In that sense, even though Mexico shares several structural shortcomings with its Latin American neighbors, the guarantee program sought to first rebuild trust between firms and banks, which had been absent for decades. This makes the Mexican experience unique as compared to other recent Latin American guarantee programs. This fact is reflected in the FUNDES survey of Mexican SMEs. According to the survey, 81 percent of firms that received a loan through the SINAFIN had not had access to any type of loan before. More than 50 percent of those firms, however, had more than enough collateral to guarantee a loan and

would have therefore had access to a loan in any other market setting. This illustrates the lack of a credit market for SMEs in Mexico.

Table 3.- SINAFIN Loans per Year

Year	Number of Loans	Accum. Loans	% Default	Average Loan	% Depth+	Total SMEs (IMSS)++
2002	600	600	7.0%	$266,606	0.1%	811,244
2003	8,382	8,982	5.9%	$271,572	1.1%	807,642
2004	22,875	31,857	1.4%	$333,885	3.9%	803,902
2005	41,512	73,369	1.2%	$296,769	8.5%	866,105
2006*	33,061	106,430	0.2%†	$231,684	12.3%	
2006**	44,081	117,450	0.2%	$231,684	13.6%	

* Septiembre 2006
** Projected, assuming the same rate of loan placement as Jan-Sep
+ Total number of **accumulated** loans as a percentage of all SMEs registered with the IMSS
++ Total number of SMEs registered with the IMSS. The 2006 analyses use the 2005 numbers
† Note that default rates usually lag behind loan portfolios. It is usually assumed that default rates become stable after three years.

From its origins in 2003 to September 2006 more than 113,000 loans were granted through the guarantee program. Loan placements grew at an average yearly rate of 75 percent (see tables 2 and 3).[12] Given these aggressive growth rates, the Mexican guarantee system is the second largest in Latin America in terms of total investment, total guaranteed portfolio, and number of loans granted (Brazil is the first). This is notwithstanding the fact that it is also the second youngest program in the region (Ecuador's program, launched in 2004 is the youngest) (Listerri et al., 2006).

Loan Placements by Firm Size and Sector

Table 4 shows loan placements through the SINAFIN by firm size and sector. Most loans (over 65 percent) have been granted to micro firms, followed by small firms (22 percent) and medium firms. In terms of distribution by sector, commerce firms have benefited the most (46 percent) followed by industry (13 percent) and services. It is not surprising that industrial firms have the largest average loan amounts, followed by service firms and then commercial firms. It is also not surprising that medium firms receive larger loans on

[12] Of the total number of loans, around 7,000 correspond to the experimental POS program which was radically different from ensuing loan products and will, in consequence, be dropped from all the ensuing analyses.

average than micro and small firms. Micro and small firms have similar default rates, but both appear to be riskier than medium firms.

Table 4.- Loans by Firm Size and Sector

		Number of Loans	% Default	Average Loan	% Depth+	Total SMEs (IMSS)++
Sector	Industry	34,896	1.8%	351,796	13.0%	267,888
	Commerce	48,949	1.1%	228,235	18.2%	268,427
	Services	22,585	0.9%	292,448	6.7%	336,707
Size	Micro	68,988	1.4%	208,628	**	
	Small	23,133	1.4%	364,072		
	Medium	14,309	0.5%	505,849		

+ Total number of **accumulated** loans as a percentage of all SMEs registered with the IMSS

++ Total number of SMEs registered with the IMSS. The 2006 analyses use the 2005 numbers

** IMSS registries have inconsistencies when split by firm size, as micro firms are sometimes classified as small and viceversa, as a result they may lead to wrong conclusions

Table 5 presents the size-sector distribution of loan recipients. Surprisingly, most micro firms are in fact micro industries, which in turn seem to drive up delinquency rates for micro firms. It is difficult to determine why micro industries have much higher default rates than the rest, but there is some evidence that this is due to a lack of appropriate fixed asset loan products. I will discuss this in more detail below.

Table 5.- Loans by Firm Size/ Sector

Sector	Size	Number of Loans	% Default	Average Loan
Industry	Micro	26,931	2.1%	307,787
	Small	5,942	1.3%	462,902
	Medium	2,023	0.7%	611,324
Commerce	Micro	27,850	1.0%	109,066
	Small	12,889	1.7%	322,763
	Medium	8,210	0.5%	484,082
Services	Micro	14,207	1.2%	215,834
	Small	4,302	0.6%	351,328
	Medium	4,076	0.5%	497,343

Loan Placements by Loan Use

Table 6 shows the distribution of loans according to its use (fixed asset loans vs. working capital). It is striking that only 4,400 loans out of 106,000 were specifically granted for fixed asset acquisitions. The table also shows that default rates for micro and small firms using fixed asset loans are significantly higher. Additionally, the table shows that even though only a small number of those loans were in industry and commerce, they actually account for most of the defaults and can therefore explain the higher rates of default observed in micro industry. While these data on the characteristics of fixed asset loans don't really explain the differences in default rates between sectors and firm sizes, they do suggest a possible answer, especially when coupled with interview data. Given the lack of real options for business owners who need to invest in fixed assets, it is quite common for an SME to take out a working capital loan and use it for asset purchases. Given that working capital loans are typically revolving lines with much shorter terms, business owners find it difficult to generate returns from their investments quickly enough to repay the loans. Even in cases where fixed asset loans are available, loan conditions are not properly matched with client needs for similar reasons as those just described.

Table 6.- Loans by Loan Use and Firm Size/ Sector

Type of Loan	Size / Sector	Number of Loans	% Default	Average Loan
Fixed Asset	Micro	4,002	2.1%	139,935
	Small	223	3.1%	478,216
	Medium	185	0.0%	442,002
Working Capital	Micro	64,986	1.4%	212,859
	Small	22,910	1.4%	362,961
	Medium	14,124	0.6%	506,685
Fixed Asset	Industry*	446*	3.1%*	395,149
	Commerce**	486**	5.1%**	264,877
	Services	3,478	1.5%	127,505
Working Capital	Industry	34,450	1.8%	351,235
	Commerce	48,463	1.1%	227,868
	Services	19,107	0.8%	322,472

* Of these 446 loans, 372 (83%) were granted to micro firms, with an average loan size of $365,000 and an average default rate of 2.96%

** Of these 486 firms, 264 (54%) are micro firms, with an average loan of $127,000 and a default rate of **7.95%**

The lack of willingness of banks to create appropriate fixed asset credit products in terms of amount and duration generates a self-fulfilling prophecy. Given that banks consider fixed asset loans to be more risky, they don't offer long-term, flexible products. As a result, firms that need a loan to acquire an asset must accept unattractive loan terms or, worse still, take out a working capital loan instead. This puts undue financial pressure on the firm which is more likely to default on the loan, thus confirming the banks' initial suspicion. At the same time, properly-used working capital loans have proven to be extremely profitable both for banks and for firms, given that they are typically used to substitute for trade credit or other much less efficient forms of credit.

Loan Placements by Bank

In the analysis of loan placements by intermediary it is worth noting the stark variation in the levels of participation of different banks. In particular, bank Alfa, Delta, and Gamma account for 64 percent of all loans. Including Epsi brings this proportion to 77 percent. Including Epsi2[13] brings it up to 93 percent. It is also worth noting that Gamma and Epsi have significantly higher average loan amounts than the rest (See table 7). In addition, even though Gamma and Epsi2 only entered the market in 2004, they are both amongst the highest in market share, which highlights their aggressive penetration strategy.

Table 7.- Loans by Intermediary

	Number of Loans	% Default	Average Loan	% Of total**
Alfa	24,860	0.3%	308,272	23.3%
Delta	24,509	1.7%	246,543	23.0%
Gamma	18,754	2.1%	380,429	17.6%
Epsi	13,864	0.7%	404,258	13.0%
Epsi2	16,846	0.2%	20,455	15.8%
Others*	7,597	5.2%	429,533	7.1%

* Includes all other Banks as well as non-bank financial intermediaries (SOFOLES, credit unions, etc.)
** Percentage of all loans granted by that bank

[13] Epsi2 is a non-bank intermediary founded by Epsi. This Subsidiary focuses on very small loans to micro firms.

Table 8.- Loans by Bank and Firm Size:

Size	Bank	Number of Loans	% Default	Average Loan
Micro	Delta	15,858	1.3%	207,087
	Gamma	15,212	2.4%	332,464
	Epsi	7,786	0.8%	337,278
	Alfa	6,794	0.2%	171,319
	Epsi2	16,840	0.2%	20,451
	Other	6,498	4.8%	295,019
Small	Alfa	10,659	0.3%	258,687
	Delta	6,898	2.6%	299,489
	Gamma	2,387	0.9%	609,032
	Epsi	2,341	0.4%	507,752
	Epsi2	1	0.0%	50,000
	Other	847	8.8%	1,129,162
Medium	Alfa	7,407	0.2%	505,246
	Epsi	3,737	0.6%	478,977
	Delta	1,753	1.5%	395,124
	Gamma	1,155	0.4%	539,720
	Epsi2	5	0.0%	28,000
	Other	252	4.4%	1,546,525

Table 8 shows each bank's client segmentation and the average loans by segment. Here we can see that Epsi, Epsi2 and Gamma have focused more aggressively on micro firms, not only because these firms are a larger proportion of their clients, but also because they are granting them significantly larger loans than other competitors. In fact, Gamma has granted larger loans in general, including loans to small and medium firms. In contrast, Alfa and Delta have mostly focused on granting loans to pre-authorized clients with lower risk profiles and as a result they have a larger proportion of small and medium firms with lower average amounts. Interestingly, larger amounts do not seem to correlate with higher default rates, which could be suggested by Gamma's higher default rates in micro firms. In fact, table 9 shows that default rates are concentrated in service and industrial firms that don't have systematically larger loans than their commerce counterparts.

Table 9.- Loans by Bank and Sector

Sector	Bank	Number of Loans	% Default	Average Loan
Industry	Gamma	13,484	2.4%	372,546
	Delta	8,246	1.2%	257,943
	Alfa	5,005	0.3%	323,704
	Epsi	2,442	0.7%	541,915
	Epsi2	884	0.1%	22,519
	Other	4,835	4.0%	447,255
Commerce	Alfa	15,793	0.2%	300,416
	Delta	11,599	2.1%	243,688
	Gamma	3,000	1.1%	403,123
	Epsi	2,916	0.5%	428,802
	Epsi2	13,828	0.2%	20,136
	Other	1,813	9.5%	475,825
Services	Epsi	8,506	0.7%	356,323
	Delta	4,664	1.3%	233,487
	Alfa	4,062	0.3%	319,803
	Gamma	2,270	1.8%	397,265
	Epsi2	2,134	0.2%	21,662
	Other	949	3.5%	250,802

Impact Analysis Using the FUNDES Survey

Loan Recipients by Bank

The distribution of firms that have benefited from SINAFIN is related to the previous absence of a credit market. The survey of SMEs carried out by FUNDES reveals that only 5 percent of credit recipients had previously attempted to apply for a loan and had been rejected. All other firms stated that they had not been interested in a loan before and had preferred to use their own resources. In many cases, firms explicitly stated that they wanted to avoid owing money to a bank. As a result, bank proactiveness was determinant in placing loans: depending on the issuing bank between 48 and 93 percent of firms accessed a loan through a pre-authorization offer (See table 10).

Table 10.- FUNDES Survey, Loan Recipients and Control Group

	Total	Recipients	Control Group	t
Number of Firms	928	620	308	
Owner age	47.07	46.80	47.61	-0.99
Owner years of experience	16.71	16.57	16.98	-0.53
% Male	0.80	0.83	0.72	4.17**
Education: Grade School	0.15	0.09	0.26	-6.47**
Education: High School	0.21	0.16	0.29	-4.28**
Education: College	0.64	0.73	0.44	9.02**
Firm Age	11.66	11.52	11.94	-0.56
Median Age⁺	9.00	9.00	8.00	
% Incorporated Firms	0.58	0.69	0.35	10.43**
Micro	0.63	0.60	0.68	-2.33**
Small	0.31	0.32	0.26	1.86*
Medium	0.06	0.07	0.06	1.08
Industry	0.13	0.13	0.14	-0.44
Commerce	0.56	0.57	0.54	0.78
Services	0.31	0.30	0.31	-0.51
Had a loan before program	0.14	0.18	0.06	5.16**
Sales 2006 ('000)	959	1,184	515	4.72**
Increased sales 2005-06	0.45	0.54	0.28	7.95**
Maintained sales 2005-06	0.30	0.29	0.33	-1.12
Decreased sales 2005-06	0.24	0.16	0.39	-7.69**

⁺ A few firms were older than fifty years old
** 5% p value on difference

Given the lack of familiarity with the segment, it is not surprising that banks began lending only to a known set of firms, namely, firms that had been their clients for a significant time. As I mentioned before, the SINAFIN left all credit decisions with the banks and placed no restrictions on their products. As a result, banks began testing the segment by running parametric models on the owners of firms using the same models that they had developed for their credit card products. Accordingly, 84 percent of surveyed firms who received a loan in 2005 had already been clients of the issuing bank. Table 6 also shows significant evidence that banks were carefully selecting firms with the lowest risk profiles. The comparison between credit recipients and a control group composed of a representative sample of SMEs shows significant differences between the two groups in variables such as education, type of firm (incorporated or not), and firm size.[14]

[14] It is important to note the potential endogeneity between these variables. An entrepreneur's education is highly correlated with whether the firm is incorporated, as well as its size. Accordingly, a higher level of education is likely linked with a more solid business. In fact, entrepreneurship research has shown that

Accordingly, loan recipients had significantly more access to an alternative form of credit (usually credit cards) before the program and, on average, had much higher sales.

Table 11.- FUNDES Survey: Loan Recipients by Bank

	Total	Gamma	Delta	T
Owner's age	46.80	45.26	48.35	-3.51**
Owner's business experience (years)	16.57	15.14	18.00	-3.31**
% male	0.83	0.79	0.87	-2.49**
Education: Grade School	0.09	0.10	0.09	0.67
Education: High School	0.16	0.18	0.15	0.97
Education: College	0.73	0.70	0.75	-1.26
Firm Age	11.51	10.28	12.75	-2.86**
% Incorporated	0.69	0.51	0.87	-10.58**
Micro	0.60	0.65	0.55	2.63**
Small	0.32	0.28	0.36	-2.06**
Medium	0.70	0.06	0.08	-1.22
Industry	0.12	0.10	0.15	-1.67*
Commerce	0.56	0.54	0.59	-1.21
Services	0.30	0.34	0.25	2.54**

* p < 10%   ** p < 5%

This strong evidence of "skimming" by banks is not surprising and does not suggest that the guarantee system did not achieve its purpose. The only way for banks to build confidence in the SME segment was to start by testing the least risky firms, identify their specific needs, adjust the banks' credit analysis processes, and adjust their loan products before launching them on a larger scale. That said, there is also evidence that some banks have been more aggressive in their promotion of new products than others. Table 11 shows significant differences between the surveyed banks in the selection of their clients. It can be seen that bank Gamma has been more aggressive than Delta. On average, Gamma clients were younger, less experienced, and less educated. They are also less likely to own incorporated firms. Delta has a significantly lower proportion of micro firms, as well as firms in services. Delta was not only more conservative in its selection of clients; it also granted significantly smaller loans with an average of $283,000 vs.

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higher education levels in entrepreneurs are systematically correlated with higher future expectations for their businesses, which likely affects the decision to incorporate a firm and the amount invested in it.

Gamma's $500,000.[15] Moreover, Gamma has a much smaller proportion of preauthorized, existing clients (50 percent) and 30 percent of its loan recipients had not been clients before.

Gamma's more open lending philosophy seems to have had an impact on its clients. On the one hand, a larger percentage (58 percent) of its clients reported experiencing an increase in sales in the year after receiving a loan than the control group (28 percent) or Delta's clients (50 percent). In addition, only 16 percent of Gamma's clients reported a decrease in sales, as compared to 39 percent in the control group. These data suggest that having access to a loan not only allowed more firms to increase their sales, but also allowed a larger group of firms to maintain their sales levels or experience smaller drops in revenue. Given the large differences between loan recipients and the control group, it is difficult to assign full causality of these effects to the loan itself. It is nonetheless suggestive that Gamma's clients, who are closer in characteristics to the control group, experienced a higher impact than Delta's clients, who were clearly selected with more conservative measures. In fact, a propensity score matching model used to determine the impact of a loan on credit recipients as compared to the control group shows that, in fact, recipients do seem to experience a positive sales impact from the loan, and that Gamma clients seem to experience a larger impact than Delta clients (see annex 1).

Firm-level Impact of Loans

To determine whether accessing a loan positively impacted SMEs, it is first important to establish what the loans were actually used for and what determined those uses. This is because the use that a firm gives to a loan (for example, investing in a productive asset vs. repaying existing debts) is likely to affect the productivity of that loan. In a similar manner, the amount of a loan and the characteristics of the business are also likely to be determinant. Table 12 shows that the majority of firms (53 percent) used the loans to finance working capital (inventory and raw materials), followed by new investments (asset acquisitions) and to a lesser extent to cover a cash flow deficit. It is worth noting

[15] Note that these amounts are different from those that come out of the loan database because the former refer to authorized amounts, whereas the latter refer to the amounts actually disposed of.

that a larger proportion of Gamma's clients gave the loan a productive use like financing working capital, while a larger proportion of Delta's clients used it to cover a cash deficit. Accordingly, Gamma clients reported a larger impact, as a larger proportion of them reported substituting less efficient credit sources and increase their sales as a result. While the survey does not provide much evidence of it, interviewees did suggest that at least a portion of this difference in impact has to do with the amount that was lent. There is a minimum amount that needs to be borrowed in order to put a loan to a productive use. For example, a commercial firm may want to substitute a supplier's loan, but if the loan is granted on a full batch of merchandise then only a loan that can cover the entire batch would suffice. In many cases, if a firm receives a lower amount than it actually needs, it can only use the loan for more trivial purposes, like daily cash flow balances. This, in fact, is also reflected in table 12, where a larger proportion of Delta's clients expressed being dissatisfied with their loan terms (26 percent) than Gamma's clients (10 percent). Both survey and interview data show that the most common reason for being dissatisfied with a loan is that it was granted for an amount that was too low to be useful.

Table 12.- FUNDES Survey. Loan Amounts and Uses by Bank and Firm Size and Sector

	Bank		Size			Sector		
	Gamma	**Delta**	**Micro**	**Small**	**Medium**	**Ind.**	**Com.**	**Serv.**
Loan MX$ '000	500	283	342	452	530	477	412	316
Cash Flow	7%	15%	10%	12%	22%	18%	10%	11%
New invstmt	32%	25%	27%	30%	33%	36%	18%	44%
Work. capital	57%	48%	56%	51%	33%	39%	64%	38%
Increased sales	58%	50%	51%	57%	70%	59%	56%	50%
Stable Sales	25%	32%	31%	29%	15%	29%	27%	34%
Lower Sales	16%	16%	18%	14%	15%	15%	17%	16%
They Substituted...								
Trade credit	43%	41%	44%	40%	43%	30%	46%	41%
Pers. Cred. card	38%	33%	40%	29%	31%	29%	37%	38%
Pers. resources	41%	39%	43%	35%	48%	34%	40%	45%
Shrholder loan	47%	39%	45%	37%	48%	38%	46%	41%
Family loan	49%	39%	47%	36%	45%	34%	47%	42%
Friends' loans	53%	43%	54%	40%	41%	28%	55%	47%
Satisfaction with the Loan...								
Dissatisfied	10%	26%	18%	18%	26%	20%	20%	15%
Satisfied	45%	35%	40%	42%	35%	40%	40%	41%
Very Satisfied	44%	38%	43%	41%	39%	40%	40%	44%

Table 13.- Loans by State

State	Number of Loans	% Default	Average Loan	% Mkt. Share+	Total SMEs (IMSS)++	GDP / Cap	% National GDP*
Aguascalientes	1,361	1.18%	277,048	10.52%	12,932	87.7	1.23%
Baja California	3,340	0.63%	263,140	8.26%	40,412	92.5	3.50%
Baja California	776	0.39%	277,212	7.73%	10,035	87.1	0.60%
Campeche	1,149	2.52%	170,136	9.06%	12,686	123.4	1.24%
Chiapas	2,568	0.43%	151,489	18.94%	13,559	29.9	1.70%
Chihuahua	2,939	0.88%	308,207	8.23%	35,703	100.3	4.33%
Coahuila	3,269	1.77%	298,903	10.86%	30,092	102.2	3.37%
Colima	946	3.38%	271,755	11.55%	8,189	71.3	0.53%
D.F.	21,330	1.35%	296,307	19.35%	110,237	189.0	21.84%
Durango	1,447	1.73%	333,720	11.95%	12,111	66.9	1.33%
Guanajuato	4,377	0.59%	296,681	10.34%	42,314	55.1	3.60%
Guerrero	1,958	0.92%	217,572	14.83%	13,203	40.5	1.68%
Hidalgo	1,117	1.61%	338,896	9.00%	12,407	41.9	1.30%
Jalisco	10,196	2.36%	295,400	13.29%	76,712	71.2	6.31%
Mexico	8,701	1.22%	275,215	15.39%	56,528	50.2	9.48%
Michoacan	3,557	0.31%	234,290	13.26%	26,823	41.6	2.21%
Morelos	1,312	1.60%	276,350	12.04%	10,898	64.5	1.38%
Nayarit	1,685	2.08%	152,523	15.47%	10,890	42.9	0.54%
Nuevo Leon	7,165	0.80%	313,057	11.71%	61,172	133.9	7.43%
Oaxaca	1,157	0.52%	268,099	9.23%	12,531	32.4	1.52%
Puebla	3,138	2.55%	383,934	11.86%	26,469	49.5	3.55%
Queretaro	1,193	0.59%	334,239	6.97%	17,117	80.9	1.72%
Quintana Roo	1,400	0.29%	244,846	10.81%	12,953	108.5	1.64%
San Luis Potosi	2,124	0.47%	295,622	10.65%	19,953	56.4	1.81%
Sinaloa	3,072	1.40%	283,675	9.13%	33,632	57.2	1.99%
Sonora	2,229	0.94%	311,972	6.61%	33,745	84.3	2.68%
Tabasco	901	0.67%	323,960	8.25%	10,915	46.4	1.25%
Tamaulipas	3,968	0.76%	261,755	11.38%	34,856	82.9	3.34%
Tlaxcala	623	2.41%	300,299	15.32%	4,067	40.3	0.57%
Veracruz	3,813	1.26%	250,542	8.85%	43,065	44.2	4.17%
Yucatan	2,164	4.30%	276,656	13.14%	16,472	58.9	1.41%
Zacatecas	1,455	0.34%	223,965	14.21%	10,239	41.8	0.76%

+ Total accummulated loans as a percentage of all firms registered as SMEs in the IMSS

++ Number of firms registered as SMEs in the IMSS. 2006 uses the same number as 2005

* Percentage of the Country's GDP in nominal pesos

Loan Placement by State

The SINAFIN as a program was designed by the federal government and was initially only offered to banks with a national presence. However, as I have mentioned before, state governments played a central role in the program, both in its design and in its local

implementation. Table 13 shows all the loans that were placed by state, together with some measures of structural factors that may influence the penetration of SME credit in a state. As had been discussed in Chapter 2, it is striking to see that, while some of the differences in penetration between states can be attributed to structural factors, structural explanations do not account for much of the difference between states. Chapter 4 delves deeper into these differences to show that they can only be explained by the process of implementation that was followed at the state level, including the extent to which state governments coordinated with the federal government, with local bank managers, and with local business associations in the promotion of the SINAFIN.

Extension Agents

The Extension Agent Program grew gradually from its inceptions in the pilot tests with Gamma and Epsi. Given the nature of the program, where it is necessary to recruit, train, and supervise agents; there is a long learning curve that must be followed but it also generates interesting results once it has been traversed. By September of 2006, the extension agent program had diagnosed 6,786 firms and obtained loans for 4,000 of them, which translated to a success rate of around 58 percent (see table 14). The table shows that, on average, loans approved through extension agents tend to be significantly higher. While part of this effect is due to the relatively low number of Epsi2 loans that have been granted through extension agents, table 15 shows that, in general, loans obtained by extension agents are of equal or larger size.

Table 14.- General Extension Agent Program Results

Extension Agent (Yes/ No)	Number of Loans	% Default	Average Loan
No	102,510	1.32%	281,226
Yes	3,920	1.68%	345,852

It is also worth noting that micro firms have been disproportionately served by extension agents as compared to small and medium firms, especially micro industrial firms (see table 16). It is also interesting to note that micro and small firms tend to receive significantly higher loans when they work through an agent. According to interviews with clients and extension agents, this is due to two factors. First, the extension agent's

role is to find the bank whose product best fits a client's needs, as well as to help the firm in the loan application process. During this process, extension agents help firms present their information in a clearer and more orderly fashion, even helping some clients prepare their financial statements. This improved presentation of files often results in better loan terms for the client. Second, extension agents often help clients understand the intricacies of their loans, and can help clients use their lines more effectively.

Table 15.- Extension Agents by Bank

Bank	Concept	No Extension Agent	With Extension Agent
Epsi	No. Loans	13,392	991
	Amount	404,588	394,145
	% Default	0.7%	0.8%
Alfa	No. Loans	24,632	459
	Amount	308,347	300,196
	% Default	0.3%	0.0%
Gamma	No. Loans	18,104	1,322
	Amount	381,152	363,974
	% Default	2.0%	3.9%
Epsi2	No. Loans	16,729	248
	Amount	20,426	25,089
	% Default	0.2%	0.0%
Delta	No. Loans	24,219	595
	Amount	245,923	296,421
	% Default	1.7%	0.7%
Other	No. Loans	7,443	314
	Amount	427,509	530,916
	% Default	5.3%	0.6%

Both the distribution of firms –larger share of micro and industrial firms—and the larger average amounts obtained through extension agents seem to indicate that the program had a positive effect on firms. It is worth remembering that the impact that a loan has on a firm is related to its amount, where higher amounts tend to allow firms to make their desired investments, plan their inventory purchases better, achieve better negotiations with their suppliers, etc. It is also important to note that these higher amounts are not the result of a selection effect where agents only focus on the best firms. In fact, the opposite is true. Extension agents in general have three sources of prospective clients. The first is

through direct search in business databases as well as direct visits. The second is through recommendations of past clients or business associations. The third is through the bank branches themselves that sometimes send a client whose file is not well presented to work with an agent. There is no reason to expect that any of these client sources would systematically yield a better selection of clients. If anything, we could expect these prospects to be of lower quality on average.

Table 16.-Extension Agents by Size and Sector

Ext.	Size / Sector	Number of Loans	% Default	Average Loan
No	Micro	66,234	1.43%	206,546
	Small	29,389	1.42%	363,442
	Medium	13,912	0.60%	506,205
Yes	Micro	2,790	2.12%	311,079
	Small	721	0.00%	404,273
	Medium	409	1.45%	484,830
No	Industry	32,972	1.82%	350,855
	Commerce	47,901	1.12%	228,041
	Services	21,693	0.97%	290,820
Yes	Industry	1,951	2.86%	390,735
	Commerce	1,068	0.37%	255,265
	Services	901	0.66%	356,058

The extension agent's work of preparing clients' applications, advising them on financial and accounting aspects, and teaching them how to use loan products is not only reflected on the quantitative data but also in interviews with clients. For a business owner, especially in a micro or small firm, it is extremely difficult and costly to leave her business to go to a bank branch to apply for a loan, as it often implies closing the business. It is also often difficult to prepare the application files in an acceptable manner, especially given how different the requirements are for each bank. Given that extension agents work with all banks, they can help a client prepare her file in a way that will better fit each bank's requirements and as a result responses to applications are more likely to be positive and to be given more quickly. Moreover, even in cases where a loan is rejected an agent may –and often does—positively impact as a firm, as she can advise it

on how to strengthen the business, improve their accounting structure, or solve pending credit bureau issues.

Table 17.- Extension Agent Program by State

	SINAFIN		Extension Agent Program				
State	**Total Loans**[*]	**% Default.**[**]	**% Default.**[+]	**Diagnoses**[++]	**Approved Loans**[†]	**% Success**[‡]	**% of Total**[§]
Aguascalientes	1,361	0.9%	3.0%	358	221	62%	16%
B. California	3,340	0.6%	0.0%	88	42	48%	1%
Coahuila	3,269	1.2%	6.3%	940	528	56%	16%
Colima	946	3.6%	0.0%	203	76	37%	8%
DF	21,330	1.3%	0.0%	55	41	75%	0%
Durango	1,447	1.8%	0.0%	237	151	64%	10%
Guerrero	1,958	0.9%	0.0%	61	18	30%	1%
Mexico	8,701	1.2%	33.3%	78	61	78%	1%
Michoacan	3,557	0.3%	0.0%	404	327	81%	9%
Morelos	1,312	1.7%	0.0%	98	11	11%	1%
Nayarit	1,685	2.1%	0.0%	254	99	39%	6%
Oaxaca	1,157	0.6%	0.0%	264	216	82%	19%
Puebla	3,138	2.6%	0.0%	763	179	23%	6%
Queretaro	1,193	0.6%	0.0%	78	27	35%	2%
Quintana Roo	1,400	0.3%	0.0%	192	192	100%	14%
San Luis P.	2,124	0.5%	0.0%	151	1	1%	0%
Sinaloa	3,072	1.7%	0.2%	1,693	1,418	84%	46%
Sonora	2,229	1.0%	0.0%	734	227	31%	10%
Tamaulipas	3,968	0.8%	0.0%	86	59	69%	1%
Tlaxcala	623	2.5%	0.0%	40	34	85%	5%

[*] Total number of loans placed in the state through SINAFIN
[**] Default rate by state, as a percentage of all loans granted through SINAFIN
[+] Default rate by state, as a percentage of all loans granted through extensión agents
[++] Number of diagnoses performed by extension agents in the state
[†] Number of loans approved through extension agents in the state
[‡] Number of approved loans / Number of diagnoses in the state
[§] Proportion of all SINAFIN loans in a state that were granted through extension agents

Extension agents can impact the firm-bank relationship in two additional ways. First, agents can act as an additional filter for banks and help them more closely follow up on a loan. Second, agents constitute an additional promotion channel for the SINAFIN in general and for banks' products in particular in a given state. If the first impact of filtering and managing loans is in fact present, it should be reflected in lower default

rates. Table 16 shows that it is in fact difficult to determine the real impact of extension agents on default rates, given that in some cases they seem to lower them considerably (small firms, commerce firms) while in others they seem to increase default rates (micro industrial firms).

The main reason why it is difficult to measure the true impact of extension agents is that, even more than in the SINAFIN as a whole, the results of the Extension Agent Program vary by state. Table 17 shows how large these variations actually are. For example, Sinaloa has performed 1,700 diagnoses (25 percent of the total) and has obtained 1,400 loans (out of the total 4,000). In addition, Sinaloa has achieved a success rate of 82 percent turning diagnoses into loans. Moreover, of all the loans that have been granted in Sinaloa, 46 percent were obtained through an extension agent. More strikingly, loans obtained by extension agents have a dramatically lower default rate than the rest (0.2 percent vs. 1.7 percent). The table also shows that it is actually two states (Mexico and Coahuila) that account for most of the larger default rates observed in extension agent loans. Aside from these two states, loans granted through extension agents show considerably lower default rates than the rest. This leads to the conclusion that a well run extension agent program can have significant positive impacts both in terms of number of loans placed, but also in allowing for larger loans while keeping lower default rates. Table 18 shows several metrics for the state of Sinaloa, where the program has shown particular strength and it is having a significant impact.

Table 18.- Extension Agents by Bank in Sinaloa

Bank	Average Loan		% Default	
	Not Extens.	With Extens.	Not Extens.	With Extens.
Epsi	371,747	315,616	1.48%	0.33%
Alfa	281,298	346,889	0.00%	0.00%
Gamma	406,492	452,244	1.02%	0.00%
Delta	252,443	256,184	3.86%	0.00%
Epsi2	18,711	22,430	0.00%	0.00%
Other	406,902	611,474	1.28%	0.00%
Average	281,749	304,007	1.69%	0.15%

Given the dramatic differences in the results obtained by the extension agent program in particular and the SINAFIN in general both at the bank and at the state level, it is important to document the best practices that were observed in the case studies. The best practices discussed in this chapter will focus only on the practical and policy implications, without addressing any of the theoretical aspects which will be addressed in subsequent chapters.

Best Practices in State-Level Promotion

Integration between federal and state governments

In all of the success cases at the state level, there was a government official who took the lead in promoting the SINAFIN and the creation of a credit market at the state level. The state ministry of the economy (SEDECO, for Secretaria de Desarrollo Economico) is naturally positioned to take this lead through its promotion director, given its organizational infrastructure and its centrality within state networks. However, there are some cases where, even though the SEDECO lacks the budget, does not have a solid infrastructure, or where the promotion director simply does not define SME credit as a priority, the state delegation of the federal SE has managed to successfully take the lead. A central aspect of this leadership process is the integration of federal and state programs, both of which are likely to be underfunded on their own. This implies the establishment of a fluid and transparent communication between state and federal officials to ensure complementarities between the programs. It is important to highlight that this goes beyond political or party affiliations and remains at the program level. It is often officials from state governments of opposition parties that establish a better communication channel with the federal government. It is also important to note that these synergies can only be achieved through a joint analysis of the existing state and federal programs to define a common strategy for their local implementation and the combination of state and federal budgets.

This process usually implies granting state-level officials detailed knowledge of all the federal initiatives (the SINAFIN, for example) to identify which specific programs are best aligned with the state's priorities. A process of negotiation between the federal and state government officials would follow to determine the joint strategy that best leverages both budgets in the implementation of local programs. States that establish a close coordination between the SEDECO and the delegation of the SE tend to attract more federal resources and develop local implementation strategies that, while diverging from general guidelines, are much better suited for the state's particular needs. At the same time, the integration between the federal and state governments can greatly facilitate business-government cooperation –discussed next—as it presents a single, united front for the private sector to interact with.

Integration between public and private sector

The SINAFIN, as I described earlier, was designed in conjunction with the private sector and it depends completely on the level and quality of its participation. As a result, even though the programs were designed jointly between the SE and participating banks, and even though the pilot products were designed by the banks to be rolled out nationally; it is still the case that local bank managers have a significant degree of autonomy and can impact how the program is implemented in their state –just like they impact all other organizational results. Accordingly, local government officials who manage to establish closer working relationships with the private sector tend to develop implementation strategies that are more encompassing and tend to achieve better program results. Such integration, however, requires a significant degree of communication to engage in joint processes of design, implementation, and supervision of the programs.

It is interesting to note that, in general, state governments in Mexico already have organizational structures that seek to promote integration between the public and private sectors, usually in the form of state development funds or local economic development councils. Such councils are usually designed to include representatives from the public and the private sectors to define the state's priorities and the programs to pursue them. Even though every state that I visited during this study had such a structure, in many

cases it operates only symbolically as a rubber-stamping organization with no true influence. Programs such as the SINAFIN, however, require a close integration between the government, local bank managers, and local business associations.

In general, bank managers and government officials of all states responded to questions about the integration of public and private sectors in the context of the SINAFIN in similar terms. They all spoke of events such as local "credit fairs" or recurring promotion events with SMEs, which have equally occurred in all states. These promotion events, however, generate varying and unpredictable results and in consequence are not a reliable way of activating a credit market. In contrast, in states where a solid integration between the private and public sectors has occurred there are significant joint efforts in the promotion and follow-up of the. Concretely, the following practices were systematically found in more successful states:

- Initial integration and communication channels.- The government official(s) who take the lead in the SINAFIN (state SEDECO or delegation of SE) in coordination with federal or state counterpart(s) organizes a series of roundtables with the regional managers of all the banks present in the state, as well as with representatives of different business associations. During those meetings, the SINAFIN is carefully explained and the participants jointly identify the specific constraints that limit the creation of a credit market in the state. Naturally, certain bank managers and business representatives show a higher level of understanding of and interest in the issues.

- Creation of working groups. - After these initial roundtables where the binding constraints are detected, the program leader creates a working group together with a few managers and representatives who showed more willingness to work on the program. This working group defines a set of potential strategies to address each of the constraints defined during the roundtables. The group also defines specific modifications that need to be made to the federal SINAFIN to make it more applicable to the local market.

- Establishment of joint commitments. – For each of the promotion strategies, each of the relevant players (state and federal governments, banks, business associations) acquires a set of commitments, responsibilities, and goals. In particular, the state and federal governments usually agree to generate special promotion opportunities for intermediaries and to invest additional resources to strengthen the guarantee programs. Intermediaries agree to achieve a set of minimum thresholds in loan placements and SMEs addressed. Specific metrics are defined for each effort.

- Definition of follow-up mechanisms. – Goals and commitments are important, but they are only as effective as the mechanisms to enforce them. These mechanisms need

constant, transparent, and fluid communication between the different actors to evaluate results such as loan placements, default rates, rejection rates, average response times, average amounts lent, sectors and regions covered, etc. Successful promotion strategies are explicitly defined as experimental and evolving. As such, they require constant monitoring of results through periodic work meetings to evaluate the efficacy of different strategies and to adjust them if necessary.

- Dissemination of results. – One of the most consistently effective strategies for the activation of a credit market has been the wide dissemination of positive results obtained by different banks in the context of the program. Government agencies are uniquely placed to do this both because they already have organizational structures that specialize in communication and because they have central prominence in local media coverage. For example, certain state governments divulge results for all the banks such as loan placements, average response rates on loan applications, and rejection rates. In addition, they create yearly awards for the most active banks. These efforts create a competitive dynamic between participating intermediaries but also allow SMEs to start seeing bank loans as a true alternative.

A final note on business associations is pertinent. Intermediate organisms, or business associations, are designed to operate as bridges between the businesses they represent and governments. This bridge is supposed to operate in both directions. On the one hand it is supposed to make business demands known to pertinent government officials. On the other hand, it can be a channel to help disseminate and implement government programs relevant to the business sector. In consequence, they constitute a natural channel for a program such as the SINAFIN. In general terms, coordination with business associations is achieved through similar mechanisms as the ones described above. However, there are wide differences in the quality and strength of business associations between states. In some states it is difficult to use associations as distribution channels because their member base is too narrow, which limits them in two ways. First, because they have relatively few members –and scant revenues from yearly fees—they lack the resources to engage in meaningful promotion efforts. Second, because of their narrow base it is not efficient for the governments to use them as channels. At the same time, several business associations in such a situation have used the SINAFIN as an opportunity to increase their membership and influence. Indeed, certain business associations have sought to solidify their presence through offering public services (such as SME loans). To achieve this, they have worked closely with governments and banks to define mechanisms that

allow the association to provide differentiated credit services (through extension agents, for example) but that also generate clear commitments for it.

Given Mexico's geographic, economic, and cultural diversity it is impossible to design a program that is equally applicable to all states. Each state has its own idiosyncrasies and constraints. Consequently, it is important to empower local actors to experiment with different versions of programs and find local solutions. While it is not possible to centrally define a set of implementation guidelines applicable to all states, it *is* possible to define an implementation *process*. Such a process would create the space for local actors to negotiate and define local versions of the federal program. As an example, the SE does not have the internal infrastructure or the budget to lead implementation efforts in every state. It certainly has the ability, however, to ensure that a local leader who follows appropriate consultation and implementation mechanisms is found in each state.

Annex 1

This annex presents results from a series of matching models ran to test the effect of loan son firms in terms of sales and employee growth. I only present the results for sales, as no consistent effect was detected on employee growth. The dependent variable is change in sales, which is actually a categorical variable (non-continuous) that measures ranges in yearly sales changes.[16]

The results are presented as follows. First, I show a summary table comparing the effect in sales of businesses that got a loan (through either bank), and then through Gamma or through Delta. It is important to point out that these impacts are measured as the effect that a loan had on a business as compared to businesses that did not receive a loan in a differences-in-differences context. Later, the complete models are presented for each group. First, I show the Probit[17] model used to calculate the propensity scores that determined the matching process. The impact measurements follow, using three different Bandwidths.[18]

For each group of models, three impact measures are shown:
ATT (Average Treatment on the Treated) .- The impact of a loan on firms that received it vs. firms that did not receive it.
ATU (Average Treatment on the Untreated) .- Impact that a loan would have had on a firm that did *not* receive a loan due to selection effects.
ATE (Average Treatment Effect) .- Average impact that could be expected for *any* firm that received a loan, independent of selection effects.

[16] The ranges are as follows: -5, decrease larger than 70%; -4, decrease between 50 and 70%; -3, decrease between 30 and 50%; -2 decrease between 10 and 30%; -1, decrease between 0 and 10%; 0, no change and from one to five with increases symmetric to the decreases presented above.
[17] It is also worth noting that all probit models include, on top of the controls shown, state effects.
[18] The bandwidth defines how similar matched businesses must be when they are matched according to their propensity score. Different bandwidths permit robustness checks on the coefficients and their stability.

Summary Table

	BandWidth	Average	Delta	Gamma
ATT	0.03	0.636737	0.483987	0.594985
	0.06	0.647055	0.535244	0.586193
	0.12	0.606311	0.576483	0.616746
ATU	0.03	0.563126	0.266391	0.715842
	0.06	0.534177	0.218776	0.711344
	0.12	0.568306	0.177115	0.746933
ATE	0.03	0.612306	0.375541	0.655218
	0.06	0.609591	0.377522	0.648566
	0.12	0.593697	0.377445	0.681629

Matching Model on Full Treatment Group

Probit (Propenstiy Scores)						
Observations		928				
LR chi2(27)		168.45				
Prob > chi2		0				
Pseudo R2		0.1428				
Log likelihood = -505.53279						
Loan	**Coef.**	**Std. Err.**	**z**	**P>z**	**[95%**	**Interval]**
Incorporated	0.774781	0.102821	7.54	0	0.573256	0.9763056
Business age	-0.00201	0.005058	-0.4	0.692	-0.01192	0.007908
Owner age	-0.00048	0.005232	-0.09	0.927	-0.01074	0.0097731
Experience	-0.00312	0.00599	-0.52	0.602	-0.01486	0.0086198
High school	0.201576	0.148886	1.35	0.176	-0.09023	0.4933873
College	0.689779	0.13283	5.19	0	0.429438	0.9501213
Industry	-0.17012	0.15441	-1.1	0.271	-0.47276	0.1325207
Commerce	0.065717	0.104143	0.63	0.528	-0.1384	0.2698334
Micro	0.202174	0.200667	1.01	0.314	-0.19113	0.5954735
Small	0.047384	0.202003	0.23	0.815	-0.34854	0.443303
Credit in 2004	0.654225	0.158421	4.13	0	0.343725	0.9647251
Other loan 2005	0.140678	0.153186	0.92	0.358	-0.15956	0.4409169
Cons.	-0.6267	0.448579	-1.4	0.162	-1.5059	0.2524959

Bandwidth = 0.03				
Variable	**Effect**	**Loan**	**Control**	**Difference**
Sales	Unmatched	-0.84194	-1.37338	0.531441
	ATT	-0.84194	-1.47867	0.636737
	ATU	-1.37338	-0.81025	0.563126
	ATE			0.612306

Bandwidth = 0.06				
Variable	**Effect**	**Loan**	**Control**	**Difference**
Sales	Unmatched	-0.84194	-1.37338	0.531441
	ATT	-0.84194	-1.48899	0.647055
	ATU	-1.37338	-0.8392	0.534177
	ATE			0.609591

Bandwidth = 0.12				
Variable	**Effect**	**Loan**	**Control**	**Difference**
Sales	Unmatched	-0.84194	-1.37338	0.531441
	ATT	-0.84194	-1.44825	0.606311
	ATU	-1.37338	-0.80507	0.568306
	ATE			0.593697

Matching Model on Delta Only

Probit (Propenstiy Scores)						
Observations	618					
LR chi2(27)	232.19					
Prob > chi2	0					
Pseudo R2	0.271					
Log likelihood = -312.26747						
Loan	**Coef.**	**Std. Err.**	**z**	**P>z**	**[95%**	**Interval]**
Incorporated	1.488392	0.139372	10.68	0	1.215227	1.761557
Business age	0.002161	0.005791	0.37	0.709	-0.00919	0.01351
Owner age	0.007404	0.006603	1.12	0.262	-0.00554	0.020345
Experience	-0.00532	0.007129	-0.75	0.456	-0.01929	0.008657
High school	0.325854	0.197863	1.65	0.1	-0.06195	0.713658
College	0.640184	0.177237	3.61	0	0.292805	0.987563
Industry	0.037723	0.193489	0.19	0.845	-0.34151	0.416955
Commerce	0.242151	0.136534	1.77	0.076	-0.02545	0.509751
Micro	0.293178	0.242935	1.21	0.228	-0.18297	0.769321
Small	0.066714	0.242152	0.28	0.783	-0.4079	0.541323
Credit in 2004	0.602908	0.199999	3.01	0.003	0.210917	0.994899
Other loan 2005	-0.01923	0.192811	-0.1	0.921	-0.39713	0.358674
Cons.	-2.7731	0.604249	-4.59	0	-3.9574	-1.58879

Bandwidth = 0.03				
Variable	**Effect**	**Loan**	**Control**	**Difference**
Sales	Unmatched	-0.94194	-1.37338	0.431441
	ATT	-0.94194	-1.42592	0.483987
	ATU	-1.37338	-1.10699	0.266391
	ATE			0.375541

Bandwidth = 0.06				
Variable	**Effect**	**Loan**	**Control**	**Difference**
Sales	Unmatched	-0.94194	-1.37338	0.431441
	ATT	-0.94194	-1.47718	0.535244
	ATU	-1.37338	-1.1546	0.218776
	ATE			0.377522

Bandwidth = 0.12				
Variable	**Effect**	**Loan**	**Control**	**Difference**
Sales	Unmatched	-0.94194	-1.37338	0.431441
	ATT	-0.94194	-1.51842	0.576483
	ATU	-1.37338	-1.19626	0.177115
	ATE			0.377445

Matching Model on Gamma Only

Probit (Propenstiy Scores)						
Observations		618				
LR chi2(27)		103.66				
Prob > chi2		0				
Pseudo R2		0.121				
Log likelihood = -376.533						
Loan	**Coef.**	**Std. Err.**	**z**	**P>z**	**[95%**	**Interval]**
Incorporated	0.329215	0.12129	2.71	0.007	0.091491	0.566939
Business age	-0.01057	0.006861	-1.54	0.123	-0.02402	0.002875
Owner age	-0.00477	0.006136	-0.78	0.437	-0.01679	0.007259
Experience	-0.00586	0.007671	-0.76	0.445	-0.02089	0.009177
High school	0.129783	0.174284	0.74	0.456	-0.21181	0.471373
College	0.747398	0.154298	4.84	0	0.44498	1.049816
Industry	-0.25954	0.18385	-1.41	0.158	-0.61988	0.100798
Commerce	-0.07187	0.120551	-0.6	0.551	-0.30815	0.164405
Micro	0.232576	0.247012	0.94	0.346	-0.25156	0.71671
Small	0.091047	0.249151	0.37	0.715	-0.39728	0.579374
Credit in 2004	0.756783	0.18487	4.09	0	0.394444	1.119121
Other loan 2005	0.291185	0.180355	1.61	0.106	-0.06231	0.644675
Cons.	-0.66301	0.527859	-1.26	0.209	-1.6976	0.371576

Bandwidth = 0.03				
Variable	Effect	Loan	Control	Difference
Sales	Unmatched	-0.74194	-1.37338	0.631441
	ATT	-0.74194	-1.33692	0.594985
	ATU	-1.37338	-0.65753	0.715842
	ATE			0.655218

Bandwidth = 0.06				
Variable	Effect	Loan	Control	Difference
Sales	Unmatched	-0.74194	-1.37338	0.631441
	ATT	-0.74194	-1.32813	0.586193
	ATU	-1.37338	-0.66203	0.711344
	ATE			0.648566

Bandwidth = 0.12				
Variable	Effect	Loan	Control	Difference
Sales	Unmatched	-0.74194	-1.37338	0.631441
	ATT	-0.74194	-1.35868	0.616746
	ATU	-1.37338	-0.62644	0.746933
	ATE			0.681629

Chapter 4

The SINAFIN Program:

Mechanisms of Institutional Entrepreneurship

Previous chapters described the sclerotic nature and historical inefficacy of the institutions surrounding the Mexican financial sector. They also showed, in 2002, a sudden break with past trends with the creation of the SINAFIN program, which I have argued was a key factor in the activation of the SME credit market. While the SINAFIN program has clearly achieved significant success and has impacted the Mexican economy dramatically, several questions arise. How can we explain that such a small program created such a broad institutional shift in such an adverse environment? Why were only some banks willing to experiment with the program? What determined that willingness? And how can we explain the varying levels of success that the program had in different states, when basic structural factors do not seem to fully explain them? As I argued above, Mexico is an institutional environment where we would not expect a change as the one we observed. For example, it is puzzling to see the banks suddenly participate in a segment that they had purposefully stayed away from, or embrace a governmental program similar to others they had previously turned down. This is especially the case given that the institutional, organizational, and political constraints that existed were significant and did not decrease during the Fox administration. If anything, they became more entrenched. To address these questions, in what follows I rule out several alternative explanations, to later argue that this is a clear example of institutional entrepreneurship which, given the structural characteristics of the program, can yield significant insights into the process through which individuals initiate and enact change.

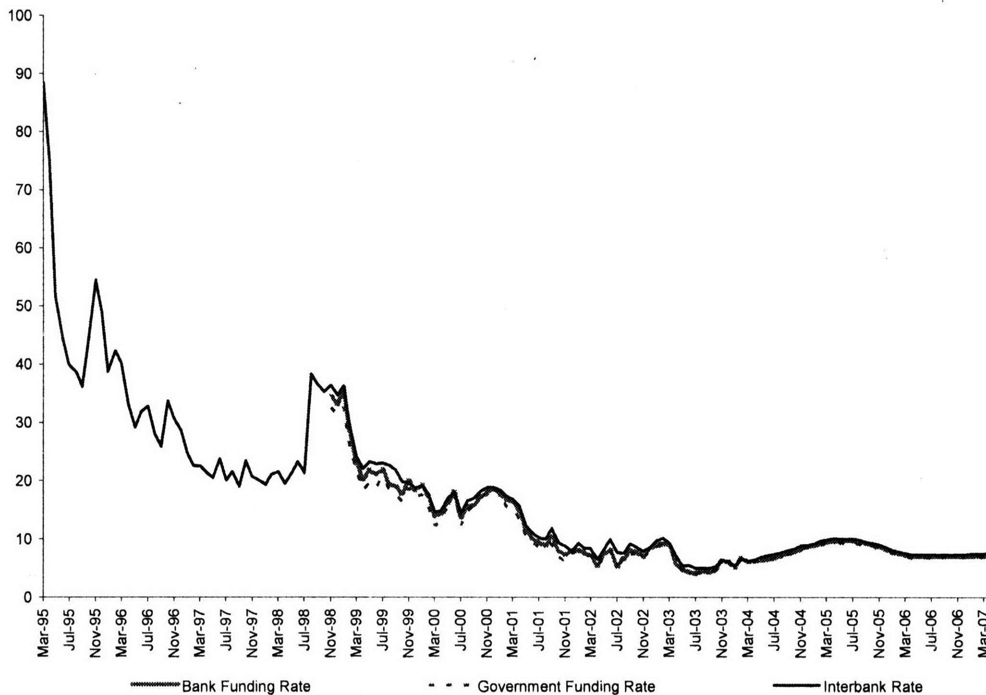
Alternative Explanations

The Invisible Hand at play

Given the size of the SME credit market in Mexico, one could argue that the transformation reflects a natural economic process where firms (banks) follow a business opportunity (SME credit) and the market is simply in the process of shifting back to equilibrium. That is, it could be that the banks were merely picking up the proverbial twenty-dollar bill that was lying on the floor. It is hard to understand, however, why they left the bill on the ground for such a long time. SMEs did not suddenly become a large segment of the business population in Mexico and their need for financing did not emerge

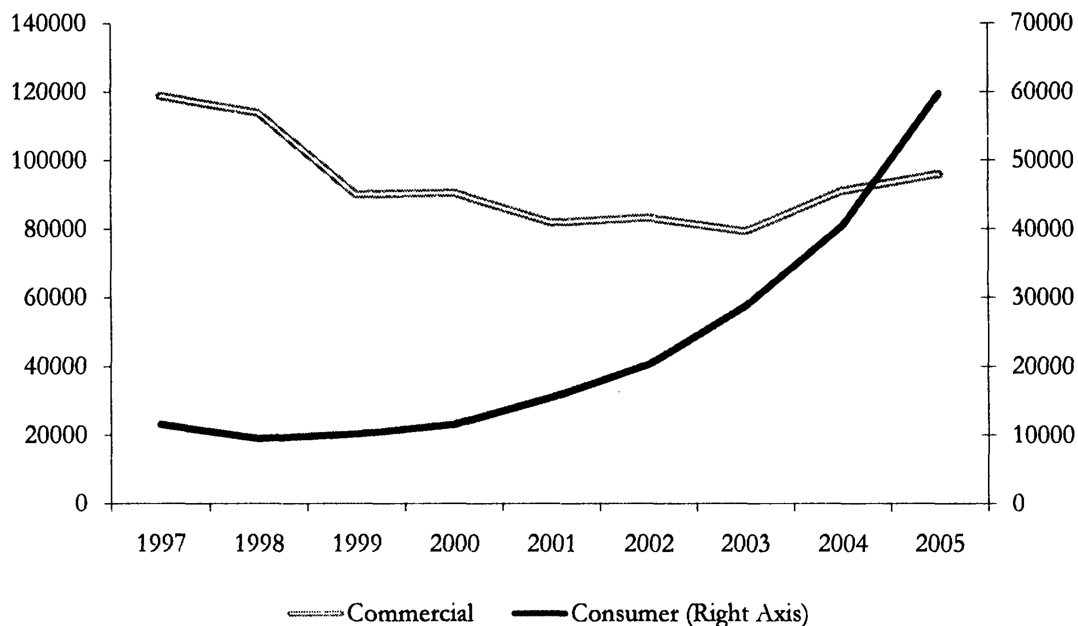
overnight. The proportion of SMEs in the economy and their relative weight and importance has remained quite constant through time, as have their basic characteristics and needs.

Fig.1.- Interest Rates in Mexico, 1995-2007 (%)



If the segment itself did not change, then maybe market conditions did. After all, Mexico suffered a terrible banking crisis in 1995. Maybe in the recovery process there was too much uncertainty for the banks to venture into credit markets. This view certainly has merit. Interest rates skyrocketed in Mexico after the 1995 crisis, and only began to decrease after the 1996 stabilization programs of Zedillo's government (see figure 1). If banks were (understandably) unwilling to lend given the high interest rate environment, it is then unclear why they did not simply create indexed loans (as they do today) or, more puzzlingly, why they increased consumer lending exponentially while decreasing commercial lending even more and staying away from SME lending altogether (see fig. 2). This was not just a matter of consumer lending having shorter terms, as a large proportion of those loans were in fact auto loans with terms longer even than the SME loans being granted today.

Fig.2.- Consumer vs. Commercial credit in Mexico, 1997-2007
(Constant 1993 pesos in Millions)

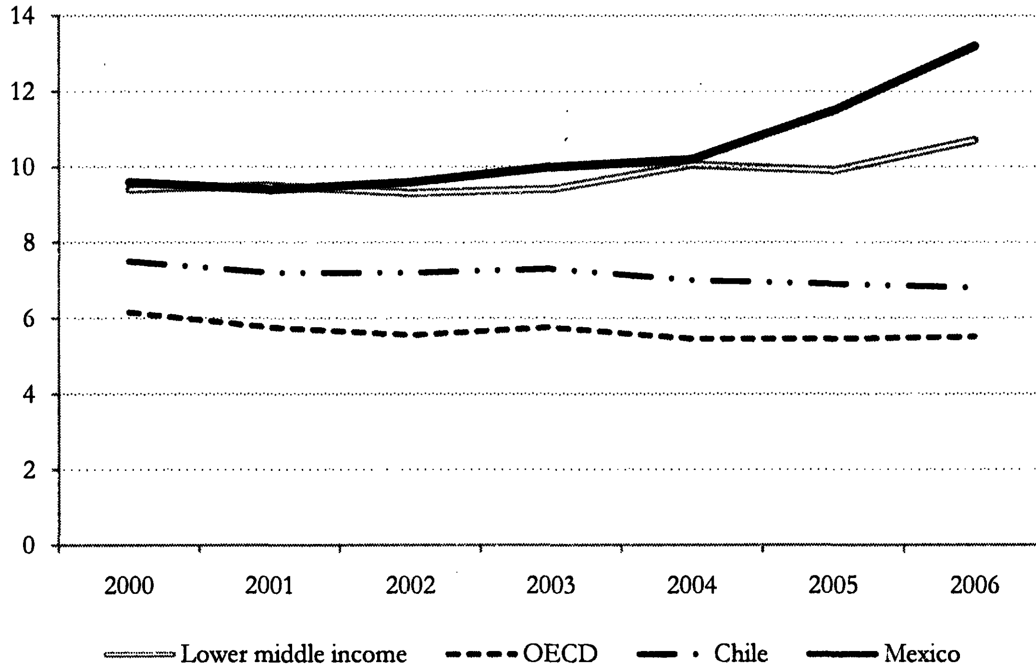


Alternatively, maybe banks were seeking to recapitalize themselves and were therefore unable to engage in business lending. After the crisis, it was indeed the case that many banks were in desperate need of capitalization, as their balance sheets bled due to issues described in Chapter 2. However, it is important to remember that, during the Zedillo administration, a wide bank bailout program was instituted to recapitalize the sector. Additionally, by opening the banks to foreign investment in 1997 most of the troubled intermediaries were bought out by larger international players with deep pockets. In fact, after 1997 Mexican banks were, on average, much better capitalized than their peers in other geographies, as figure 3 clearly shows.

Finally, taking solely a market-based account would make it hard to explain the variation we see between states in the penetration of SME loans. That is, we would expect either states that are richer and more active economically, or the ones that have larger SME markets, or the ones that have better and safer institutional environments to have larger relative numbers of loans. As I showed in Chapter 2, however, this is not what we

observe. In fact, even though we do see "good" states like Nuevo León or Jalisco show high levels of penetration, we also see states such as Chiapas, or more dramatically Michoacán, that show quite high levels of penetration even though their structural characteristics would lead us to predict the opposite.

Fig.3.- Bank Capital to Assets Ratio, Selected Countries (%)



Interest Group Politics in Action

Another potential explanation would be that disenfranchised SMEs developed mechanisms to coordinate and exercise collective action. It could be that, as more and more SMEs struggled to survive and felt excluded from policy decisions, they banded together in increasingly powerful business associations that, through political pressure, managed to place SMEs in the political agenda. Such an explanation would fit quite nicely within the Mexican corporatist political system. In fact, business associations in Mexico are recognized as being atypically strong and well organized (Schneider 2002) and have played an important role in facilitating vertical relations between the State and business and in influencing policy in positive ways (Olson 1986; Doner and Schneider 2000; Schneider 2004). Much of this strength derived from the PRI corporatist model that

explicitly excluded business from politics, thus creating a large incentive for business to organize (Camp 1989). This incentive was reinforced by an often threatening government dependent on populist policies that led to the creation strong, oppositional voluntary organizations (Durand and Silva 1998). At the same time, government has often required the support of the business sector to implement policies and reforms, and to invest in strategic sectors. Accordingly, in exchange for collaboration with government officials, the State has endorsed corporatist business associations through mandatory membership and granting them monopoly over certain government programs (Ross Schneider 2002). For example, national firm registries, some tax procedures, and several government programs were operated through national business associations and their local chapters. As a result, associations could charge relatively high fees without necessarily offering attractive benefits.

The love-hate pattern of business government relations, however, led to the creation of an array of specialized associations (Ross Schneider 2002). On the one hand, big business promoted, funded, and strongly participated in voluntary organizations that sought to create ideological (and material) opposition to the government. On the other hand, business government cooperation was established through corporatist, mandatory associations, which incorporated small business. With the passing of neoliberal reforms in the 1980s and 1990s (epitomized by the signing of NAFTA), there were significant schisms within corporatist organizations, as small producers and industrialists were negatively affected by the reforms. What followed was a gradual capture of these associations by political parties, where opposing firms were excluded from the corporatist agreement and grouped in opposing associations, later sponsored by opposition parties (Shadlen 2000). As a result, corporatist associations were weakened and the ability of small firms to coordinate was decimated. Furthermore, during the Zedillo administration important changes were made to corporatist laws, membership to associations became voluntary, and most government programs and services were made available directly through government channels. What followed was a gradual but dramatic weakening of corporatist associations, as they suddenly lost their guaranteed revenue streams and found

themselves unable to provide services that would justify charging a membership fee. Additionally, as they lost their monopoly over certain government services and programs, they became less politically central, further weakening their position (Schneider 2002). While big business voluntary associations have maintained their strength and political clout, as they had always depended on their oppositional efficacy for survival; small businesses in Mexico have lost any mechanism to successfully aggregate interests and influence policy in a significant way.

In the case of the SINAFIN, while it is true that some business associations –especially at the state and municipal level—that have managed to establish themselves as valuable aggregators of firms have been instrumental to the success of the program, in most cases government and bank officials have struggled to find good channels to communicate with SMEs in order to both inform them of the new programs and products and to receive more timely feedback on their progress. That is, in the cases where state-level associations have been more active, the initial contact and push for the programs did not come from them. Rather, it was the state governments in conjunction with the banks that sought the business associations as distribution channels and offered the loan programs as mechanisms for them to strengthen their service offering and presence with potential and existing members.

SINAFIN and Institutional Entrepreneurship

The SINAFIN program presents an interesting window into the process through which purposive action can initiate institutional change. SMEs became a central part of government policy not through social movements or due to market pressures. They entered the policy agenda because Fox's campaign team realized that SMEs had not been traditionally grouped as a political constituency and they saw a significant political opportunity in them. They decided to use SMEs as one of Fox's campaign differentiators and developed a commitment to address their issues through policy.[1] SMEs entered the

[1] A famous quote by Herminio Blanco, Minister of the Economy for President Zedillo, read: "The best industrial promotion policy is to have no industrial promotion policy."

presidential campaign embodied in Fox's promise to "look at the 'changarros'[2] and strengthen the economy around them. Once Fox was elected and a team was charged with the task of developing such policies, the SME team toured the country meeting with different state governments, local business associations and chambers, banks, and SME owners with the specific goal of initiating a broad change. While at the beginning of their quest none of these actors had a clear idea of what specific programs they needed to create, they did have a clear goal in mind: to transform the financing environment for SMEs. The result of their efforts was the SINAFIN program.

This is not, however, just a simple story of the state using its capacity to implement a new, transformative policy. State capacity is defined as the ability of officials to "implement effectively both policy objectives and specific programs" (Gilbert and Howe 1991) and is a function of instrumental resources including money, trained personnel and formal powers, and also of the infrastructural resource of bureaucratic development. (Skocpol and Amenta 1986; Pedriana and Stryker 2004). The Ministry of the Economy, however, did not have significant resources, was lacking trained personnel given the historical absence of SME policies, and is a weak ministry within the government structure given its meager budget and its absolute lack of coercive power (it is a ministry designed to coordinate economic actors and promote economic activity, so it has no enforcement activities and no enforcement leverage). This is reflected in the fact that, as I argued before, other programs with similar goals had previously existed with poor results. Given that state capacity did not change with the transition to the Fox administration, and in fact it was diminished as the executive power lost the "presidentialist" quality of the PRI years, the success of this particular program goes beyond simple policy implementation.

In fact, the SINAFIN as a program was different in several respects. First, it was a federal program, ran from a central government agency, and designed as a state promotion policy. Previous attempts had been administered at the state government or development

[2] "Changarros" is the Mexican slang term for a very small business, typified in a 'mom and pop store'

bank level. Second, it acknowledged previous mistakes, the Ministry's weakness, and was thus designed in conjunction with the banks that chose to participate. That is, while previous guarantee systems had been designed by the state or development agencies and offered as established products to the financial sector; banks were involved in the inception and design stages of SINAFIN and the program developed in a stepwise fashion, where early stages were specifically rolled out as experiments between the SE and participating banks to learn what solutions would work.[3] Third, because the program was designed in conjunction with the banks and addressing most of their needs and concerns, specific goals and commitments were set between the different players, where clear rewards and punishments were defined. Fourth, the SE decided to leave all credit decisions solely in the hands of the banks to avoid any risk of clientelism or government intervention in loan grants. This also marks a departure from previous programs where credit decisions were either made directly by government agencies or the central development bank performed a second credit analysis on all the loans that had been previously approved by operating banks.

What the SINAFIN program provided, in fact, was an incentive for the banks to experiment with a segment that they had traditionally overlooked in a relatively risk-free manner. Both the SE and the banks saw the initial, relatively small stages of the SINAFIN as experimental: for the banks it was a way to test both the SME segment *and* the SE. For the SE it was a way to test the program and the relationship with the banks. As the banks developed pilot products for SMEs and started testing the segment, they *discovered* that there was a much larger demand for loans than they had anticipated, that they could potentially standardize their processes to make the segment economically attractive, and, more importantly, that the SME segment was much less risky and default-prone than they had anticipated. Initial estimates of expected default rates ranged from seven to ten percent. Data in chapter 3 above shows that, in fact, these were wide overestimations. Once the three leading banks began aggressively marketing to SMEs,

[3] The idea to use the banks as partners was a central aspect of the program. Given their national presence, their deep pockets, and their reach in number of branches, it was deemed that they would provide the best channel to quickly generate loans for SMEs. Several other alternatives were considered, however.

the rest of the banks jumped into the segment and developed products of their own as a response to the competitive pressure.

The success of the SINAFIN is therefore best explained by the process through which it was designed, and the innovative solutions it generated. Of particular importance were the decisions by SE officials to first perform a thorough diagnosis of the SME constraints to later engage bank managers in the design process of the program. The design of the SINAFIN, then, cannot be separated from the individuals –from different organizations— who participated in it. As I will detail below, these individuals followed a complex process of experimentation, resource redeployment, coalition building to quell political contestation, and much iteration in all of these to initiate the changes that we now see unfolding. The efforts of these individuals were a defining factor in the institutional change caused by SINAFIN. But this only raises additional questions. How can we explain the sudden emergence of SMEs as a priority for the government? Why did these government officials decide to follow such a different process in the design of SINAFIN? Why did managers within certain banks decide to participate in the program? How were banks that were openly uninterested in SMEs, lacked organizational capabilities to address them, and were skeptical of government programs in general able to coordinate with government agencies on this? Put differently, the SINAFIN program was an initiative launched by institutional entrepreneurs within the government to generate a partnership with institutional entrepreneurs from private sector organizations. But how did these individuals become institutional entrepreneurs? And why did they succeed where others had failed?

The Mechanisms behind SINAFIN

The structural characteristics of the SINAFIN program, as I have mentioned before, are particularly suitable for addressing such questions. Both because it emerged in an adverse institutional environment and, more importantly, because of the internal variation it presents in its results it allows for the exploration of the mechanisms that determine success. The focus of the research was to isolate these mechanisms through the

comparison of structurally equivalent organizations (national banks) as well as states that nonetheless varied in their success at activating the SME credit market. It was through this strategy, in fact, that the role of institutional entrepreneurs became salient in the first place. That is, what was common between and distinctive of the successful cases within SINAFIN was the central –and clearly identifiable—role that certain individuals had in detecting, launching, and driving the change process.

Table 1.- Characteristics of Institutional Entrepreneurs

An Institutional Entrepreneur presents *all* of the following:[†]
Opportunity Recognition: - Recognize the importance of SME financing. - Believe that current institutionalized views of the segment are wrong and should be changed. - Understand the economic and/or political opportunity that the issue presents for their organization.
- ***Institutionalization Project:*** - Identify internal barriers that prevent their organizations from successfully exploiting the opportunity. - Seek to change or remove them through an "institutionalization project" (usually a pilot test). . Seek organizational resources for experimentation, support from other areas to design and implement the experiments, and support from their superiors to bend or break existing rules. . A clear example of this would be a bank manager who, recognizing the bank's lack of understanding of the SME segment and lack of credit analysis skills to lend to it, sought to create a pilot program to lend to a small number of SMEs and learn about them. To achieve that, she would need to engage in extensive area-spanning efforts to find support from other areas of the bank, including commercial (to design the test product and to get some branches to test it), credit analysis (to create a first pass of a credit analysis process), and legal (to include a minimum set of requirements). She would also need to find the financial resources to grant those experimental loans, which would require the approval of the treasury or financing area.
- ***Inter-organizational Brokering:*** - Recognize that, due to broader institutional barriers, true success would only be possible if a wider institutional change is achieved. - Identify that such a change would only happen if all or most of the relevant organizations and stakeholders are involved. . Actively seek to broker and coordinate efforts with other organizations to create the leverage required for a broader institutional shift. . An example of this would be a state government official who brokered efforts between the local government, the federal ministry of the economy, local bank managers responsible for the deployment of experimental products, local business associations sensitive to local business' needs, and local media capable of diffusing information about the efforts.

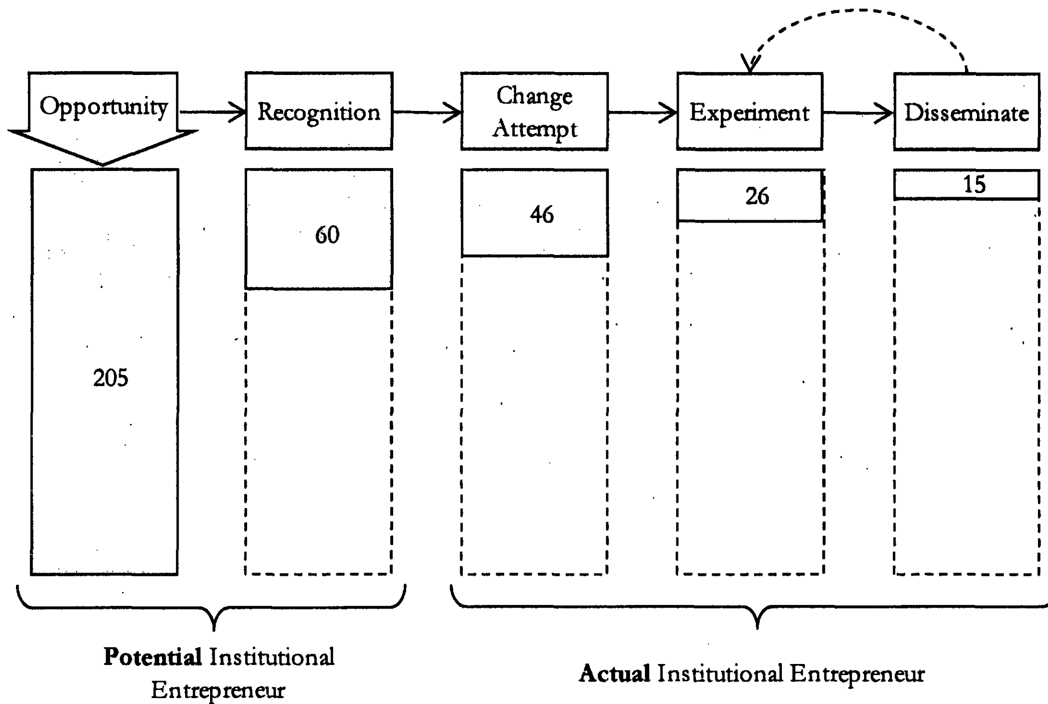
[†] *Note that these were not self-reported qualities. Only an individual that was described as presenting these behaviors by others was recognized as an institutional entrepreneur.*

The initial identification of these individuals was illuminating for two separate reasons. First, traditional theory on institutional entrepreneurship, as I have argued above,

explicitly or implicitly portrays an image of institutional entrepreneurs as extremely unique individuals, the relative absence of which explains why institutional change does not occur more often. What emerged from my observation of SINAFIN, however, was quite different. Even using a restrictive definition –specified in table 1—individuals who could be identified as institutional entrepreneurs were present in all cases, successful *and* unsuccessful. While they could be clearly differentiated from –and identified by—their peers as institutional entrepreneurs, and while they were clearly a very small minority within their organizations, their numbers across different cases were strictly at odds with a "messianic" view.

Second and related, in following the stories of these individuals and their change efforts, the picture that emerged was different from traditional views where a relatively linear path can be traced from the success of an effort to its beginning and where –in retrospect at least—the path can be predicted from initial institutional conditions or the characteristics of the individual pursuing it. What did emerge, however, was a consistent set of roadblocks that individuals in different organizations and geographies encountered when seeking to initiate change. The ability to overcome these obstacles allowed some individuals to progress in the path to change while others were left behind. This suggests a different approach to the study of institutional change. Instead of thinking of it as a linear process, it implies conceptualizing change as a sequential process, where a series of relatively unlikely events must all occur for efforts to succeed. This sequential approach recognizes the existence of successful *and* unsuccessful change efforts, it accounts for the observation of larger numbers of *initial* entrepreneurs, and it allows us to understand the specific mechanisms that filter individuals at each stage. Note also that it is consistent with the empirical reality of infrequent instances of change. That is, even if we assign relatively high probabilities of success at each of the stages, the fact that they must *all* happen result in a very low overall probability of success. Figure 4 presents the different stages that I observed all change efforts go through, as well as the actual numbers of individuals I recognized at each one.

Fig.4.- A Stage Model of Institutional Entrepreneurship



The central argument of this chapter, then, is that purposeful institutional change is not rare because there is a lack of institutional entrepreneurs and only extremely unique "great (wo)men" can envision it. Institutional change is uncommon because it requires an unlikely combination of an opportunity for change with an individual who can recognize it, has the capabilities to pursue it, *and* is situated in the right structural position to drive a change process. The proposed stage model underscores how individual capabilities of institutional entrepreneurs interact with organizational and political structures in processes of institutional change. More specifically, it highlights the mechanisms that explain institutional experimentation: how individuals develop the motivation to experiment, under what conditions they can turn that motivation into actual experimentation, and what determines whether the experiment results feed back to create institutional change. Once an opportunity for change arises an individual must recognize it, develop the motivation to pursue it, decide to launch an experiment, find enough support and resources for it, disseminate its results (if the experiment was successful), and continue in this sequence until a self-reinforcing process of institutionalization begins. Note that this approach focuses squarely on social mechanisms (Coleman 1990;

Hedström and Swedberg 1998) by exploring the macro-micro links that determine when we may expect an institutional entrepreneur to arise and when we would expect her to succeed. It straddles different levels of analysis to uncover how structural elements interact with culture and individual characteristics to affect agency (Stinchcombe 1965; Vaughan 1998; 1999). Also note that I am only focusing on one particular type of institutional entrepreneurship, namely, when individuals *explicitly* seek to change an institution. This is in contrast with, say, "accidental" institutional entrepreneurship, which could occur when individuals inadvertently change an institution as an unexpected result of pursuing other goals (Li et al. 2006).

*Table 2.- Distribution of Institutional Entrepreneurs at the State Level**

	Campeche		**Michoacán**		Puebla		Querétaro		**Sinaloa**		Sonora	
Type of Organization	**N**	**I.E.**	**N**	**I.E.**	**N**	**I.E.**	**N**	**I.E.**	**N**	**I.E.**	**N**	**I.E.**
State Government	2	1	3	2	3	3	2	0	5	2	3	1
Local Bank Managers	3	1	5	3	4	2	4	2	4	2	4	2
Business Associations	3	1	3	0	1	0	2	1	4	2	3	1
Delegation of the SE	2	0	2	0	2	1	3	0	1	1	2	1
Overall	10	3	13	5	10	5	11	3	14	7	12	5

* Note that loan officers, business owners, and extension agents are not included in the tally
** Successful states in **bold**

I detected institutional entrepreneurs –as defined above—who invested significant time and energy in their efforts, often risking (and in some cases losing) their jobs, in every one of the eight national banks that I analyzed; even though they were only successful in three of those banks. I also detected the presence of institutional entrepreneurs in all of the state cases, distributed among different organizations. Table 1 displays, for each state, whether I detected institutional entrepreneurs –according to the definition specified above—across the different types of organizations involved in small business credit. It can be seen in the table that institutional entrepreneurs were not uncommon within the

development of the SINAFIN. Moreover, there was no stark difference in their distribution across different organizations or across states.

At the same time, table 2 shows, for a sample of federal organizations and states, that there were differences in the degree to which these entrepreneurs were successful. It also shows the distribution of individuals across the different stages of change. Success, of course, needs to be characterized. In my earlier discussion of the SINAFIN variations, I characterized success at the state level according to the penetration achieved by SME credit. For the narrower context of institutional entrepreneurs in organizations either at the state or the federal level, however, I coded successes or failures according to the *moves* or particular projects that the actors created (Goffman 1981) as well as the diagnoses and evaluations that those involved in the project (both the institutional entrepreneurs and other relevant actors) had of the results (Benford and Snow 2000; Howard-Grenville 2007). As an example, an institutional entrepreneur at the state level could be a regional bank manager who, seeking to take the most advantage of the SINAFIN program, tries to engage local business associations and the local government in a project to improve the credit culture in the state. For this purpose, she pushes for a series of well-advertised events where local businesses are informed of the products and where the bank offers their loan product; as well as house-to-house promotion through extension agents and local government officials. There is therefore a clear institutionalization agenda, and the results are measured against it in the form of loan placements and loan applications by all the actors that were engaged in it–i.e. how they all answered the question of whether "it worked".

In the remainder of this section I will explore the mechanisms that link the macro and micro aspects of institutional change at each of the described stages. I will first explore how institutional entrepreneurs detect opportunities for change, develop an awareness of alternative options, and develop the motivation to engage in experimentation. I will show that institutional entrepreneurs require backgrounds that are mixed in terms of the groups or communities of meaning that they span (Piore 1995), which allows them to recognize

change opportunities that others in their vicinity can't detect, as well as provide them with the language and cultural tools required to communicate such opportunities in a convincing way (Swidler 2001). Additionally, they require the political skill to build coalitions and convince their superiors and peers to engage in an uncertain process of experimentation (Sabel 1993; 1994; Rodrik 2006) by creating a specific project (Colomy 1998) or symbol (Ansell 1997) that distinct groups can all work around. While most of the insights that I will introduce in this subsection have already been developed in one form or another, their presentation through the mechanism framework will hopefully provide clearer links between different existing concepts, and will also pave the way for the subsections that follow.

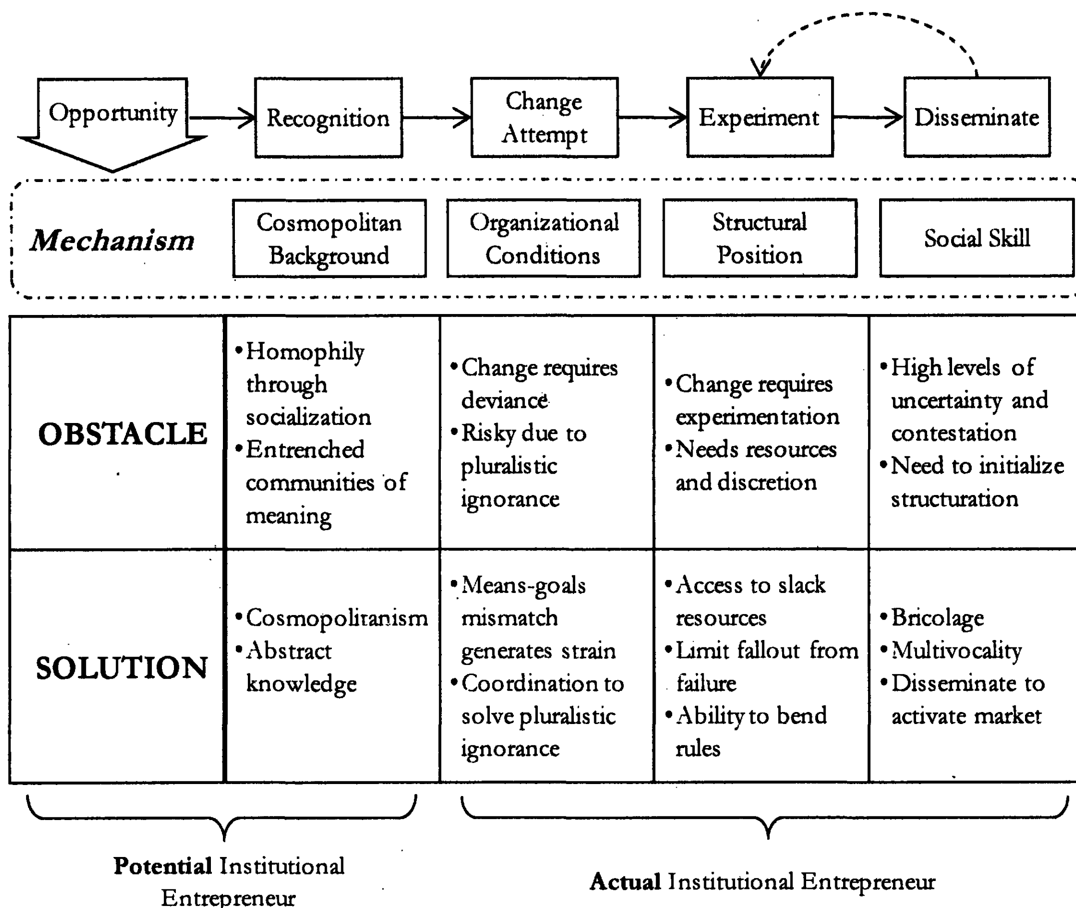
Table 3.- Distribution of Institutional Entrepreneurs across Stages

Case	Opportunity Recognition	Attempt at Change	Experiment	Success
NAFIN	5	3	1	0
Economy	5	4	3	**3**
Delta	2	1	0	0
Alfa	3	2	2	**1**
NGO1	2	1	1	0
NGO2	2	1	1	**1**
Sonora	8	5	2	0
Sinaloa	10	7	5	**4**
Querétaro	5	3	1	0
Michoacán	7	5	3	**2**
Total	49	32	19	**11**

Second, I will discuss the mechanisms that determine whether the detection of an opportunity and the motivation to experiment will actually result in the initiation of an experimentation process. I will argue that the distinct set of individual capabilities–mixed backgrounds and skill—must be matched with a structural position that grants an institutional entrepreneur access to the necessary resources to engage in experiments, as well as the necessary level of legitimacy and discretion to perform them. Due to the uncertainty inherent in experimentation and the resources required for it, only certain structural positions will enable individuals to engage in it. More specifically, I will show

that it is positions of middle management that provide the right balance between access to resources, legitimacy, and discretion. At the same time, it still holds that only middle managers who have a specific mix of background and skills will be successful in their attempts –or even be aware of the possibility. Finally, I will discuss the mechanisms that determine whether the results of an experimental process will be translated to change. I will argue that the actor-structure interaction will again play a role in determining whether experimental results are widely diffused and thus become a new element of public knowledge (Adut 2004; 2005), to initiate a process of common belief transformation (Kuran 1989; 1997) and institutionalization of new practices. Figure 5 summarizes the argument. It shows, for each stage, the mechanism that filters individuals, as well as the obstacles the stage presents and the solutions allowed by the mechanism.

Fig.5.- The Mechanisms of Institutional Entrepreneurship



Opportunity Recognition: Cosmopolitanism from Personal Background

Some individuals within the banks, either because they had been entrepreneurs before entering the financial sector or because of other career path accidents, were exposed to the SME segment more intensively and realized that many of the assumptions of the SME segment held by others within their banks were simply wrong. For example, a standard explanation for not engaging in business credit was that SMEs were insoluble and could not afford a bank loan. Some individuals who had been more intimately involved with the segment, however, knew that SMEs typically used financing options that were much more inefficient and that a substitution for bank credit would release more than enough liquidity to pay for a loan. As Adrian, a manager within one of the major banks who later was one of the strongest promoters of SINAFIN and eventually became manager of all SME products within that bank recalled:

> "I was hired to develop B2B models for the bank during the Internet boom, in the e-banking area. As I worked on that I realized that the SME segment was huge, it was where the real meat of the market was. I was also surprised to see just how neglected it had always been by the financial sector. There were basically no SME products of any kind (...) I quickly found out that nobody [in the bank] knew that segment well, nobody knew what they wanted, what made them tick. (...) From that moment on, I would interview SME owners at every chance I got, and people at the bank started to see me more as the SME guy than the Internet guy."

In a world such as the banking sector, where socialization processes are particularly strong (Van Maanen and Schein 1979), managers are promoted from within the banks, and experience in the financial industry is a primary source of recognition and advancement, bank employees rarely have access to external sources of information. Accordingly, managers such as Adrian, who get the opportunity to straddle the border with other worlds, are quite scarce (Smith 1990; Weeks 2004). The following quote from a bank manager reflects the more typical view:

> "Yes, we have been invited by the government to participate in the program and yes, some of our branch managers say that small businesses are asking for loans. But to be honest, I can see no reason to participate in the program. We have a set target of lending both at the national and at the branch level, and we meet eighty percent of that target easily by lending to local and federal governments. We can meet the rest of our goal through our larger corporate clients. Why would we ever need to lend to SMEs? It's not like we don't make enough money. Just the complexity of analyzing each loan would make it a nightmare. On top of that, we don't know if they are going to repay us!"

A similar contrast can be seen when comparing the state delegates of the SE in Sinaloa and Querétaro. During the Fox administration, it was established as policy to only hire state delegates for the SE from the private sector, as they would establish better connections between the government and local business. Accordingly, both the delegates of Querétaro and Sinaloa had been prominent business people before being designated. That said, the Sinaloa delegate had become prominent as a serial entrepreneur who founded and developed several successful businesses in the state. As a result, when the SE first approached him with the idea of SINAFIN, he very clearly understood the importance of the program and was aware of the political opportunity it represented in the state, given his intimate knowledge of the SME segment. Accordingly, he became a central piece to the program in the state, constantly building bridges between the state government, the SE, local business associations, and local bank managers. The Queretaro delegate, in contrast, became prominent as a director of one of the largest industrial conglomerates in the state. His priorities as a delegate, he said, were to make sure that local companies were able to access export markets. For him it was hard to understand why, as a government official, he should help banks promote "their own products" given that it was "their job" to place loans.

Members of the financial sector in fact form a tight community of meaning (Piore 1995) through their constant –and closed—interactions. In such a network with high homophily, a "cosmopolitan" member that can straddle borders and access external information may suddenly become more powerful, depending on the value of that information and her ability to use it (Reagans and Zuckerman 2007). Notice that cosmopolitanism may exist because an individual has actually belonged to different communities of meaning or because she has simply interacted with them but has a personal ability to internalize different cultural languages. In the latter cases, however, a legitimacy claim, which as we will see is important to justify the potential costs of experimentation, is harder to make.

A cosmopolitan member doesn't only have access to new information, she also has access to different cultural languages that allow her to understand that information and,

more importantly, to "translate" it in such a way the core members of the group will accept it. Once the Internet boom collapsed, an international bank acquired Adrian's corporation and he was reassigned to an area charged with process optimization. Because he had to engage in long negotiations to change the processes at different areas, he gained deep knowledge about each of them. He kept his knowledge about the SME segment, but also acquired valuable knowledge about all the areas in the bank, their specific incentives, and their languages:

> "The SINAFIN program was a huge opportunity for the bank, and it killed me that people weren't seeing it more clearly. For the CEO it was a great political position because the federal government was trying to promote the sector, if we seriously engaged with them it would work to our advantage later. Additionally, I had learned that the SME segment is incredibly loyal given the neglect it has historically suffered from, so if you give them adequate service they can become a great source of recurring revenue through commissions and cross-selling, which was a great opportunity to increase our market penetration. The government was willing to absorb part of our risk, so the downside potential was quite limited. To top it all off, because it was a developing market I knew the margins on the loans would be large, so the project would be profitable. The rest of the bank seemed to just not see it though, it was like a nightmare."

Note how Adrian speaks specifically of the reasons each of the bank's areas had to be enthusiastic about the program. In his interview, Adrian described in detail how he used that knowledge to speak in different terms with each of the areas of the bank, highlighting the potential benefits for each area *in their own language*. Adrian's background allowed him to develop a more diverse repertoire of languages and cultural tools (Swidler 1986; 2001), which he strategically used to convince each of the departments as they reacted with skepticism to the idea of considering SMEs as an attractive segment (Padgett and Ansell 1993; Padgett 2001). Moreover, as he spoke to each of the areas, Adrian highlighted different motives for acting on the SINAFIN opportunity (Wright Mills 1940), and by speaking to each of the actors in their own languages, he was also able to translate and import concepts from one group to the other:

> "Adrian was instrumental in intermediating and negotiating. He would make the communication flow between the lawyers, the analysts, and NAFIN, and he would constantly try to find meeting and understanding points between the parts. He was basically a translator, because people really couldn't understand each other. He would basically ask an area: "how can we make such and such fit within the framework of your processes?" and then he would take that information, change it a bit –sometimes a lot--, and present it to the other area in a way they could understand and embrace it."

This ability to speak different languages and import concepts from different networks by morphing them into a culturally acceptable proposition has been documented by different authors that describe processes of institutional change (e.g. Rao et al. 2003; 2005). What has mostly been missing from these descriptions, however, is an explanation of why certain agents and not others choose to (try to) engage in experimentation, and what determines whether they will succeed. The case of Manuel, another bank manager, is illustrative. Manuel developed an awareness of the SME opportunity through his work in government-sponsored agricultural loans. While this was a very profitable area of his bank, it was purposefully kept relatively separate from the rest, as it had a very different way of operating.[4] As he helped manage relationships with farmer associations, he was exposed to many credit-worthy SMEs, and developed an understanding of their potential. When he sought to sell those ideas within the bank, however, he was not successful. He simply lacked the detailed cultural knowledge to explain his ideas to different areas.

> "The rest of the bank saw us (his area) as outsiders, and I couldn't get them to listen to me. I could never get past their perception that these firms were too risky and too expensive to lend to."

Organizational Conditions: Coordination, Experimentation, and Pluralistic Ignorance

The Importance of Experimentation

If institutions are instruments that provide certainty, then it follows that institutional change –or a diversion from existing institutional configurations—is fraught with uncertainty. Indeed, one of the largest impediments to institutional change is the natural adversity to uncertainty of the players involved. Institutional entrepreneurs are usually keenly aware of uncertainty, as one of their central tasks is finding ways to manage it. In the words of Jaime, the initial promoter of the SINAFIN and the government official in charge of it:

[4] During the Salinas and Zedillo governments, the government launched new lines of support for farmers. Because the government budget traditionally has a lag of several months over the projected date, the government asked banks to provide bridge financing for a few months. The role of the bank was to disburse funds to farmer associations, and later collect from the government. For this service, the banks were paid an intermediation margin of six percentage points –note that there was absolutely no risk involved.

> "I would love to tell you that we knew exactly what we wanted to do and how to do it, and all the changes that you see now were planned from day one. The fact of the matter is that we had no idea what we needed to do. The worst part was that we *knew* that we had no idea what we needed to do and that nobody else did. [...] One thing I did know was that we needed to develop a broad strategy, a State-level policy framework that would guide our efforts. The idea was not to just fulfill the requirement of creating a new proposal for the Fox government to show. The idea was to make sure that the new government *did* have a clear policy focused on SMEs.[5] At the same time, because we knew that we didn't know what was needed, we couldn't just make up a document, we needed to engage in discussions with all the relevant actors."

This acute alertness to uncertainty was not the exception but rather the norm for the institutional entrepreneurs I observed, who constantly needed to find ways to navigate and mitigate it during the change process. The existence of uncertainty and the entrepreneurs' ability to recognize it are what makes experimentation a central aspect of institutional change (Hirschman 1985; Rodrik 2006; Forthcoming). As I have argued above, changing an institution requires shifting a stable set of public beliefs which in turn entails demonstrating that those beliefs are wrong or that an alternative path is more effective. At the same time, actors have no way of predicting the true results of change efforts, as they are sailing in uncharted waters. All they can do is engage in smaller, marginal experiments to test whether alternative paths are indeed more effective, and use that evidence to convince others. Broader diversions encounter too strong a resistance, and are likely to flounder before they are born.

In the beginning stages of SINAFIN, the priority for the Ministry of the Economy was not to design an airtight program (which they didn't really know how to do anyway), but to convince the banks to engage in a discussion, test a segment that they believed was worthless, and develop a common understanding of its issues (Sabel 1993; Uzzi 1997). This led to a series of initial –failed—experimental programs that only sought to build trust and learning between the parties. As a government official engaged in the initial stages recalled:

> "I hated the (initial) program. It was so far from what we really wanted to do that I saw it as a waste of time and money. We were basically giving money away to (bank name) so

[5] It is useful to remember that, during the previous administration of president Zedillo, the then minister of the economy made the famous remark that the best industrial promotion policy was not to have one.

> they would place (some small loans) at no risk, and we were achieving almost zero in activating credit.[6] Jaime (the government official in charge of the program) agreed with my sentiment, but he explained that we had to find a way into the banks, even if it was through the back door, and the (initial) program was exactly that. Time ended up proving him right."

The bank managers confirmed that they were not only testing the SMEs, but also they were testing their counterparts:

> "When the SE approached us and offered to work with us, it all sounded great, but given our previous experiences with the government and with NAFIN we didn't know if we could trust them. We saw the (initial) program as a very low-risk way of "testing the waters". When the program began and the SE immediately committed the funds and they repaid all our initial losses on time, we realized they really meant business, and we opened up much more after that. (...) It was a very important advance for us because at the beginning, when we were selling all of this internally, the word in the bank was that we would never be able to make it work, because the government was not trustworthy (...), and because the economics of the segment would not work out. It simply seemed too hard, to uncertain."

Midway through this initial program, the bank asked to halt it because of its poor results, much to the surprise of the SE. More importantly, they explained that the program had allowed them to gather some new information on SMEs and given them time to think about a better system. They offered to use the unutilized portion of the initial program funds to start a guarantee pilot project, under a better scheme, to give out 1,000 loans to SMEs. In a similar fashion, a different experimental program had been run at a second bank, as explained by Adrian:

> "As I mentioned, we (Adrian and some close collaborators) had been trying to figure out a way to attack the SME segment, because we knew it was unattended. It was really hard for us, partly because the bank had an institutional reticence towards the segment, which it perceived as too risky. When the SE approached us with the idea of backing our loans with a guarantee, we saw it as the perfect opportunity to test the segment without incurring too much risk. It gave us a perfect argument to create momentum in the commercial areas and to convince the credit areas who didn't want to take the risks."

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[6] This experimental program consisted of placing Point of Sale (POS) machines in small businesses. Because POS require a PC to operate, the bank would provide a loan for the PC, backed by a government guarantee at 100%. The program failed because most SMEs had access to cheaper PCs in the second-hand market, which satisfied their computing needs. Its success, however, lied in that SMEs were interested in the POS and this provided the bank with much information on their transaction activity, liquidity levels, and payment habits.

Overcoming Pluralistic Ignorance

It is one thing to realize that change is fraught with uncertainty and that experimentation is the way to go about it, but it is quite a different thing to actually decide to engage in it *and* convince relevant actors to join in such experiments (Sabel 1993; 1994). On top of the specific knowledge that institutional entrepreneurs need to possess, as described above, they must have the necessary social and political skill to actually build coalitions around their ideas and manage to push their experiments through (Fligstein 1997; Beckert 1999; Fligstein 2001; Howard-Grenville 2007). That is, so far it has become clear how differing logics can develop within a single institutionalized setting and how, at any particular point in time, these logics can coexist. It has also become clear why, given how entrenched the dominant logics are and the uncertainty around potential outcomes, only showing actual results of an alternative could create a shift. It is still unclear, however, how individuals decide to suddenly break with the establishment and dare to deviate by experimenting with new behaviors. For an individual who can envision an institutional alternative, the biggest barrier to deviation is pluralistic ignorance: it is impossible to know how many other people would agree with her view, would support her experimentation, and would be willing to join in (Kuran 1997). The risks of deviation are, however, clearly large. A clear illustration of this phenomenon is a quote from Aung San Suu Key, the detained opposition leader in Myanmar:

> "Myanmar is like a frozen river: it looks still, but who knows what turbulence is roiling the waters under the ice?"

This description could actually apply to all institutions. The fact they are stable, and that all we can observe are external signs that confirm that stability, does not mean that there is no turbulence beneath the surface. Obviously, institutions differ both on the thickness of the ice and the amount of turbulence under the surface. A critical question, however, is when individuals under the surface decide it is possible to break through. Jaime's description of the development of the initial action plan shows how the barrier of pluralistic ignorance was overcome in Mexican SME finance:

"The PDE[7] started as the list of things that I would have liked to have as a business owner.[8] I basically wrote down the initial index and with that we went out and consulted with all the relevant parties. [...] As we toured the country and we talked to business chambers and entrepreneurs, and as we learned about the state governments' experiences, we began incorporating ideas to the plan. We would sometimes take entire structures that had given good results, like the Jalisco development fund (FOJAL) and copy them directly to our plan. What we ended up with was a 'chilaquil'[9] that we circulated to hundreds of people. The end point of the process was a two day symposium that we organized where we invited academics, business owners, bank managers, the presidents of all the business associations, all the ministers of economic development from the states, and representatives of other sectors of society and we had a series of very chaotic roundtables to discuss the contents of the document. All my staff took notes of all that was suggested and we incorporated all those changes to the document, which became the PDE that you see today. (...) Mind you, the end product was not so different from my initial version, it really wasn't, and some of my staff members questioned me about the apparent loss of time and effort following such a long process only to end up close to our starting point. My goal in this process was not only to learn more about SME needs, but also it was to make sure that all the people that would be a part of the program felt some sort of ownership of the PDE. I needed to generate their commitment, and I could only do that if they felt like they had also written the document. (...) This often meant looking like a "pendejo"[10] and asking very stupid questions on purpose, to get other people engaged."

What the PDE first achieved, which was later consolidated in the SINAFIN program, was the development of an institutional project (Colomy 1998) that the different organizational players could focus on. A project provides an easier route into experimentation because it is clearly bounded and it therefore reduces the potential downside in the eyes of the players. Additionally, the SINAFIN was a clear symbol that all the organizational actors could agree upon and use as a common language both between them and within their organizations (Ansell 1997). It allowed individuals from different organizations to initiate collective action around an issue that, given its broad nature –initiating a market—required a minimum critical mass to function. Contrast this

[7] PDE: Plan de Desarrollo Empresarial, or Business Development Plan. It was the initial document prepared by the Ministry of the Economy where the broad strategy of activating SME loans through banks was laid out.
[8] His background was as a serial entrepreneur in agribusiness in the state of Veracruz. He became one of the largest coffee exporters in Mexico and also commercialized other food products. It was through his influence as a business owner that he was pushed to run for congress by the Veracruz business associations, and from there he was asked by Fox to head the SME area of the SE.
[9] Mexican dish consisting of a mixture of tortilla chips, green or red sauce, cream, cheese, and shredded chicken.
[10] A dumbass.

with a state government official's response to a question on the promotion of the programs he did with the banks:

> "I don't promote the programs with them. Why should I? The government has already designed the program, that's as far as our job should go. We are already offering them a tool to make more money. We already made the sandwich; I can't see why I need to chew it for them as well."

Notice how the story of the SINAFIN could potentially be told in retrospect as a story of one institutional entrepreneur (Jaime) who envisioned a transformation and saw the project to its fulfillment. The story, however, is much more complex than that. First, after the initial round of experiments with the banks Jaime could not oversee the next stages as he was transferred to another government agency that was facing a crisis. A new official was assigned to head the program design effort, and he continued quite successfully where Jaime had left off (he was subsequently also replaced, also successfully). Second, it is important to remember Jaime's contention that they didn't really know what needed to be done, and the program actually developed out of the interaction between *a group* of institutional entrepreneurs sitting in different organizations (Sabel 1993; Ansell 1997; Morrill and Owen-Smith 2002). An important part of this process then required finding the right people to talk to, and building alliances with them:

> "We took the idea of the program to all the banks: my team would talk to the middle managers and my boss would talk to the CEOs. My philosophy was always to look for people that really wanted to work with us. If the operational managers were lukewarm about the idea, we would simply stop working with them. We had a lot of work to do, and we couldn't waste our time with people that just didn't get it, so we were looking for people who were willing to deeply engage with us."

The most important accomplishment of the PDE process, then, was to allow potential institutional entrepreneurs to identify each other and overcome their pluralistic ignorance. It brought into light who understood the SME credit issue, who was *willing* to join in the collective effort, and who was *able* to mobilize resources around it. It is telling, for example, how Adrian –who has illustrated many of the examples above—became involved in the project in the first place. As I already mentioned, after heading the B2B initiative (and becoming the SME expert in the bank), he was integrated to the reengineering area of the bank. He was in fact not at all involved with the commercial

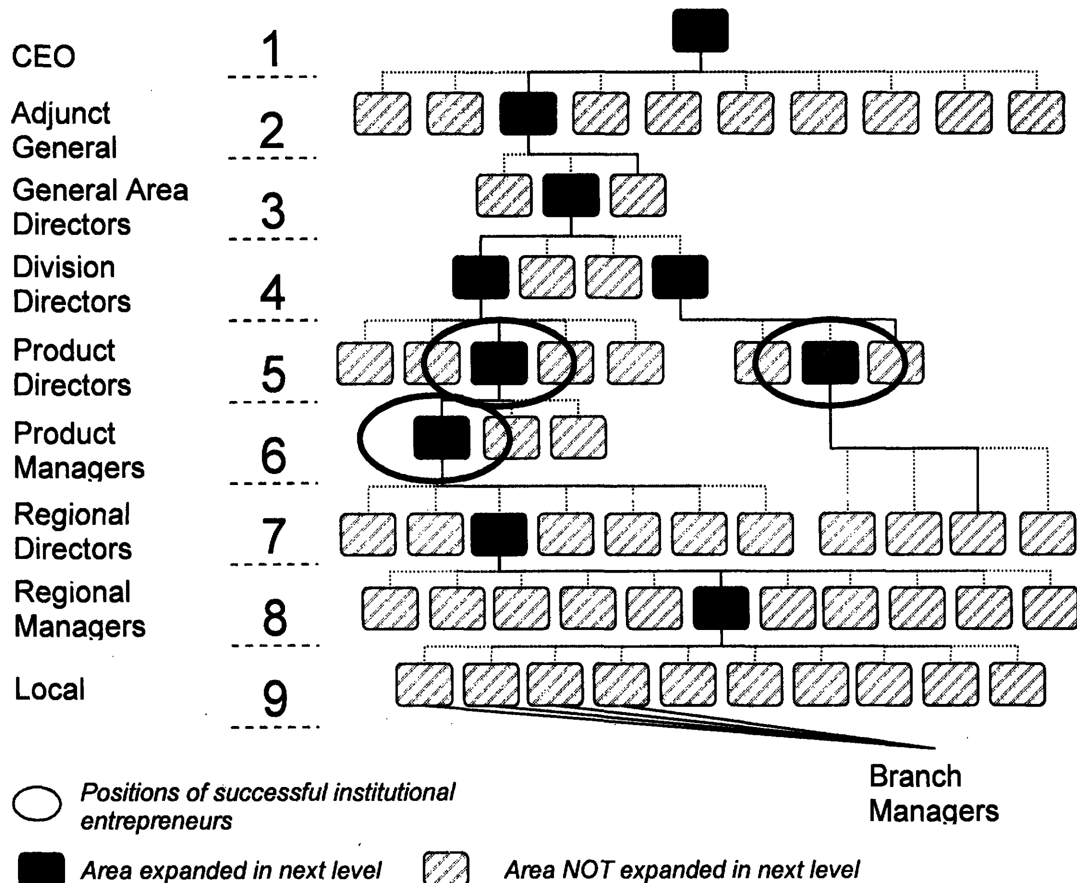
area, which was the right interlocutor for the SE on new product discussions. When the roundtables began, Adrian was asked to join the commercial area as an advisor, given his knowledge of the segment. During the PDE process, it became clear to him that the SE was serious about the effort and that enough people from other organizations were also engaged. As the negotiations continued, however, both Adrian and the SE officials became increasingly frustrated with the lack of understanding –and as a result the lack of commitment—that the commercial manager officially in charge of the negotiations had about the SME segment. Eventually, while still retaining his reengineering job, Adrian took over the negotiations and became the interlocutor with the SE and other banks.

> "The commercial manager and I both agreed that it was the best thing to do. He did not understand the segment and did not find it interesting. He was convinced that the efforts would lead nowhere and he saw the meetings as a distraction from his real work. For me, it was the opportunity I had been looking for to finally do something to address the SME segment. I had to keep the two jobs for a long time, it was not until the SME area of the bank was officially created that I was able to stop working on process redesign. That was three years after the initial negotiations began."

Structural Position: Becoming Deviant

One of the most striking factors about the success cases in the SINAFIN program was not only that institutional entrepreneurs were instrumental in driving the success or that they followed similar strategies in their efforts, but also the extent to which they were all situated in similar hierarchical positions. In every single instance of a successful change effort the individual driving it was positioned in the upper-middle levels of the organizational structure. Moreover, they were all situated in outward-looking areas of the organization. For government agencies, this meant a third or fourth level officer; for banks, it meant middle managers usually sitting within the commercial areas of the bank. The same pattern was observed at the state level as is represented by figures 6a and 6b, where the structural positions of successful institutional entrepreneurs are highlighted.

*Figure 6a.- Generic Organizational Chart –Banks**



The structural position was a determining factor in whether efforts for change were successful because, to become an institutional entrepreneur, individuals must both be *willing* and *able* to engage in experimentation. Experimentation requires both an appropriate access to resources and the ability to deviate significantly from existing norms of behavior. At the same time, given that experiments are mostly considered marginal activities within organizations and are therefore not a priority, they are usually carried out with slack resources. But accessing such slack resources requires a level of familiarity with the organizational structure that only managerial positions can provide. A useful example comes from a manager in one of the most aggressive banks that not only experimented with creating a new SME product, but also with developing SME-specific bank branches:

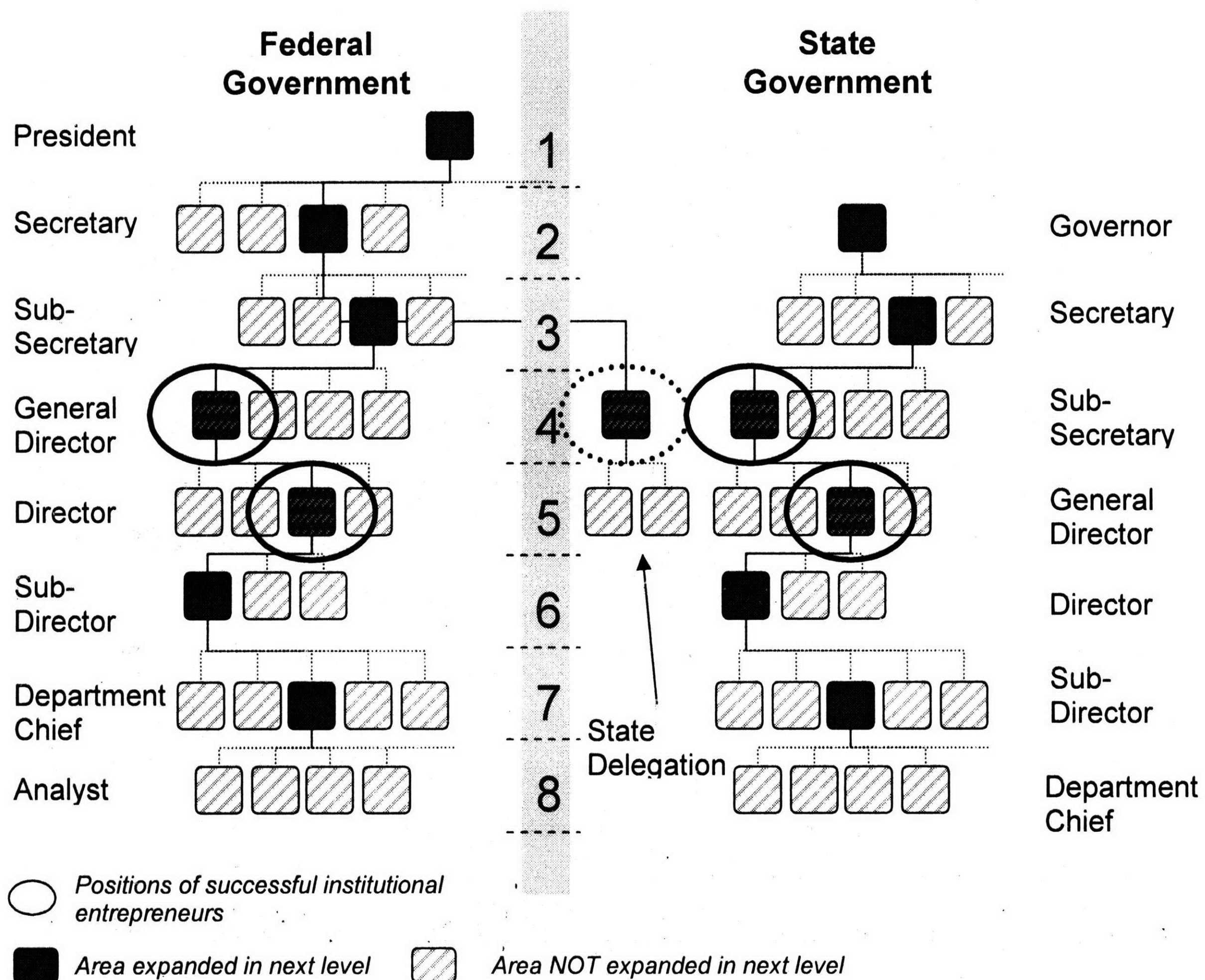
> "Once the SE contacted us to participate in the SME program I asked to be part of the team and I ran a market study. Through that study we realized that the SME segment did not trust banks, as they perceived them to be too complex due to their regulations and size. Additionally, given their own size, they did not see themselves as attractive client prospects for the banks, so they had no intention of approaching a branch for a financial solution. When I saw these results I realized that we could not really get to this segment through the traditional branches, we needed to create a new image for SMEs. I moved around in the bank and I found three branches in different cities that were not being used but were owned by the bank, and I moved around with my connections to borrow furniture and old computers from different bank branches. Once I had equipped the branches I asked my boss (the commercial director of the bank) to let me run a pilot program with the three branches, with a limited amount of resources to lend in an experimental way. When he saw that the required investment was basically zero, and the financial risk was limited due to the government guarantee, it was an easy project for him to approve."

On top of requiring resources, an experiment implies divergence from a norm. Institutional entrepreneurs are, by definition, deviants. It follows that an institutional entrepreneur must have both the motivation and the discretion to deviate.[11] While most of the deviance literature has focused on criminality, institutional innovation as a type of deviance was identified from its origins, for example, in what Merton called "non-conforming" or functional deviance (Clinard 1964). From its origins, the study of social deviance has argued that a basic paradox of the structure of society and culture is that while it seeks to produce patterned behavior, under certain conditions it generates deviance; namely, when a mismatch exists between cultural goals and structural means to achieve them, which generates significant strain (Merton 1938; 1949). Organizational structures present particularly clear examples of this, given the ambiguous definition of their goals, their clear hierarchical structures, and the often constrained resources that managers must operate with (Yaeger and Reed 1998; Vaughan 1999; Simpson and Leeper Piquero 2002). Middle managers are in a focal position within organizations as they represent the sole filter between top management and supervisory staff, and are responsible for carrying out top management's directives, which are often fuzzy and broadly defined, with limited resources. This generates especially large levels of strain,

[11] Note that here I am referring to a different type of motivation than previously. Earlier I spoke of the motivation to experiment as opportunity recognition. In a structural account, however, that is not enough. Here I am speaking of motivation as the structural pressure to deviate, as in Merton's strain theory.

and generates significant pressure for them to deviate (Clinard 1983).[12] At the same time, middle managers must be granted significant leeway: in situations where broad goals are defined, the pressure to perform is large, and resources are scarce top managers know that discretion must be exercised (Lipsky 1980; see also Chapter 5).

*Figure 6b.- Generic Organizational Chart –Government**



While the concept of social strain is useful to understand why middle managers would be more likely to develop a motivation to deviate, it does not suffice. To fully understand deviance it is important to understand the *process* through which a person who has

[12] Note that an ethics culture, mostly personified by top managers, will greatly determine whether the strain will result in criminal behavior, see (Clinard 1983; Grojean et al. 2004)

conventional motives, goals, and self conceptions is *deemed* deviant by others (Matza 1969). More specifically, strain theory would predict that there are a large number of individuals who experience similar levels of motivation to deviate, and who are deviant *in fantasy*. The question is how that fantasy turns into a fact. In other words, being predisposed to deviate is not the same as being *willing* to deviate, which is not the same as being *able* to deviate; and it is in the conversion process that the most crucial questions lie (Becker 1953). This suggests that there are three stages of the deviation process: the first is developing the motivation (from strain) to deviate, which may lead to deviation as fantasy. The second is being willing to deviate or actually deciding to engage in the deviant act, which may occur once pluralistic ignorance is resolved and the risks of deviance become less uncertain. The third is being able to deviate, or actually becoming successful in the attempt, which requires both having access to sufficient resources and having the leeway to bend or break existing rules.

Two parallel examples, within two of the most engaged banks, may help illustrate the process of becoming an institutional entrepreneur. In both of these banks, the managers that initiated the experimental process were middle managers sitting in the equivalent of position six of my generic organizational chart of figure 6A. One of them (who I have introduced before), was in charge of developing a B2B internet solution for the bank. The other (Raul), was in charge of a credit card product. In both cases, their bosses gave them very broad, but very ambitious goals: in the case of Adrian, he was to have a large number of businesses trading on the B2B solution by the end of the year, which implied creating a new market and convincing a large number of businesses to join. In the case of Raul, he was to replicate the previous year's growth rate in new credit card activations, which entailed placing a large number of new credit cards. It is important to note that the individual credit card market had been growing aggressively (see figure 2), and that Raul was convinced that penetration of existing credit card products was reaching its sustainable level so placing more credit cards to individuals at such an aggressive rate would imply taking undue risks. In both cases, then, they were under much pressure from their superiors to find a large number of new customers but were not given any specific

tools to achieve this. Because both had experience with the SME world (both had been entrepreneurs in "previous lives"), and both of them were aware that the SME segment was the largest untapped market in Mexico, they saw it as a great option to achieve their goals, but they were also aware that it was not a legitimate segment to go after. Coincidentally, it was when they were both exploring the option of the SME market as a segment that they learned about the SE's programs and they immediately jumped at the opportunity. It was in the process of following up on the opportunity with the SE and dealing with the strong opposition from the rest of the bank that they truly became institutional entrepreneurs, as it was only through breaking existing norms that they could pursue it.

In similar fashion, an official within the state ministry of the economy of Michoacán explained his involvement with the program:

> "We were the first state government to be elected from the left-wing party. It was important to make sure that small companies felt represented by the government. (...) The Minister and the Governor told me that I had to create high-impact programs for SMEs. (...) At the same time, we are a poor state; we simply don't have resources to invest heavily. The only solution I could find was to leverage federal funds as much as possible. My priority was to get as much money from the federation as I possibly could, and make the federal programs work in the state. (...) This was not easy to sell internally, after all, the federal government is from the PAN (right-wing party). From the beginning of my tenure, therefore, I got involved in as many federal committees as I possibly could, and I became engaged in the definition of SINAFIN so I could bring as much of it as I could to my state."

In contrast, when describing the culture within NAFIN (the development bank that had traditionally run guarantee programs and tried to block many of the SINAFIN's most innovative features) an official from the SE explained their reticence to change:

> "I worked in NAFIN for many years and only left because I was offered a great opportunity in government. As a manager there, you get the best salary and the best benefits you could possibly imagine. That is why most NAFIN employees have been there twenty years. Most of them are very capable people, but they just don't take risks. After the 1995 crisis NAFIN lost a lot of money and many people had to go. Those that stayed built a culture that protects their jobs over everything else. They don't have aggressive goals, and they don't take aggressive risks."

The previous examples help illustrate how the managers' complex hierarchical position may generate pressure (strain) and thus the motivation to engage in experimentation. For some, their background and knowledge of the SME segment, and their belief that most of the assumptions that existed about the segment were wrong, provided them with the willingness to take the risk of actually experimenting. What is missing in both cases, however, is how they went from being willing to being able to experiment. In these two, and in the other instances of SINAFIN, a middle management position allowed actors enough knowledge of the organizational rules to understand which norms needed to be bent or broken in order to advance an experiment, which of those deviations were more likely to be accepted, and which norms were impossible to question. Additionally, it granted them the structural legitimacy necessary to engage in rule-bending both because they could achieve the necessary buy-in from upper management and because they had enough status in the organization to avoid being questioned about every decision. Note, however, that it was important for the managers to be high enough in the structure to have access to resources, the discretion to mobilize them, and the legitimacy to bend certain rules; but it was equally important to be *low* enough in the structure that their deviations would not be too visible and would therefore suffer from premature political resistance or would have larger organizational consequences (Phillips and Zuckerman 2007). It is no coincidence that the whole SINAFIN program developed out of the SE, which has traditionally been a "second level citizen" as governmental agencies go. Jaime specifically explained that other agencies are much too visible to allow for such experimentation without bumping into significant political contestation from other agencies or from opposing political parties. The following quote nicely shows this ability to go unnoticed:

> "When I finally convinced the president of the political opportunity of the SME constituency, we had to convince Hacienda (Treasury) to give us funding. We didn't ask for that much to begin with, but at the same time they didn't really think we would do much with the money, they just didn't think much of the SE, and did not pay much attention to us. I later heard that (the minister) simply said: 'give them their budget, let them do their little show, it shouldn't amount to much'."[13]

[13] I later corroborated this quote with officials from Hacienda, who confirmed the story.

In comparing successful vs. unsuccessful cases of the SINAFIN program, and as I mentioned above, I was surprised to find that individuals who recognized the SINAFIN opportunity and actively sought to change their organizations or states through it abounded. What later became apparent, however, was that only a few of them had the right combination of mixed backgrounds, skill, and a favorable structural position. In some cases, for example, bank managers had clearly seen the opportunity for their bank and had actively tried to mobilize resources around a pilot program, but they were too low in the structure to have the knowledge and access required to succeed. In one of Mexico's largest banks, for example, a manager who had been an entrepreneur before clearly understood the opportunity that SINAFIN represented. He was situated, however, exactly one hierarchical level below the rank of other successful entrepreneurs. His boss, situated in the "ideal" structural position, had only worked within the bank and logically saw the proposition as too risky. All this institutional entrepreneur was able to mobilize was the money required for a preliminary market study, which took several months and "only ended up in my boss' drawer". Not surprisingly, the bank has lagged behind significantly in the program, and support for it within the bank is still sorely lacking.[14]

This contrasts with another case of a mid-sized bank, where it was a top manager who was enthusiastic of the idea but he could not find an interested, knowledgeable middle manager to see the project through with the energy that was required.[15] In this case, it was impossible for the manager to engage in it himself for two different reasons. First, he was concerned that his personal engagement –and deviation from traditional norms—would be seen by the entire bank, and he worried both about the precedent it would set and the potential repercussions of a failure (Phillips and Zuckerman 2008). Second, he simply did not have the time or discretion required to follow through. His "legitimate" daily activities were much too cumbersome to leave any room for other tasks. The idea was delegated to a middle manager in the commercial area, but the lack of enthusiasm of this

[14] In my interviews with government officials and managers from competing banks I was often asked to explain why this particular bank, one of Mexico's largest, was simply not reacting. For managers in the commercial areas who understood the size of the market opportunity and who had "converted" to SME financing, it seemed puzzling that this bank wouldn't "get it".

[15] For similar findings in the innovation literature see Burgelman's papers on organizational entrepreneurship: Burgelman 1983a,b; 1994.

manager turned him into one of the people that Jaime chose not to work with directly. Because this program was not a top priority for the top manager, he could not supervise the efforts thoroughly and resources were never mobilized.

Disseminating Results: Institutionalization of New Practices

Experimentation generates learning about the efficacy of different types of solutions that may both challenge existing beliefs and pave the way for future experimentation, but such learning is not useful if it can't be transferred across and up the organization. Institutional entrepreneurs must not only launch experimental efforts, but also need to make sure that whatever is learned is properly diffused. Moreover, they must think hard about the transferability of learned lessons, as different actors interpret such lessons in quite different ways according to their specific interests (Morrill and Owen-Smith 2002). Two examples illustrate this well. During the SE negotiations with one of the first banks to join, the bank mentioned that they had been running some simulations and they expected their losses to be of around 5-7% of the portfolio, so they asked the SE to guarantee (only) those expected losses. Given that the SE team did not have a strong financial background, the concept of "expected losses" was new to them, and was quite different from traditional government guarantee systems where the government guaranteed a percentage (that could range between 50 and 100 percent) of each loan granted, thus requiring more resources and a less predictable amount of them. It resonated well, however, given that the SE was keenly aware of the limits of their budget and was constantly looking for ways to leverage it as much as possible. They launched a pilot program with the bank that failed –mainly because of the lack of credit analysis experience with the segment—and had to be stopped mid-way. Unsuccessful as it was, however, it achieved the important purpose of teaching the SE about expected losses and their estimation through simulation, which later became a central part of the guarantee program as they transferred that idea to other banks. A counter example is the case of one of the state governments that had actually experimented with their own, simpler version of a guarantee program several months before the national program began. Because their experimentation happened at the state level and only small local financial institutions

were involved, they had much trouble scaling their program even though it achieved interesting results, as they found it hard to diffuse their experience. Interestingly, some aspects of these experiences were later captured by Jaime during his national tour and incorporated into the broader, national strategy.

Diffusion is crucial because institutional change doesn't only signify the creation of new norms. It also entails the institutionalization of existing yet under-enforced practices (Adut 2004). A process of institutionalization hinges on the transformation of public beliefs, and mechanisms that can turn the private knowledge of institutional entrepreneurs into public knowledge can quickly cement this process (Kuran 1989; Parkhurst Ferguson 1998; Rao *et al.* 2003) and will certainly speed up mimetic processes of institutionalization (Haveman 1992; 1993; Haveman and Rao 1997). Processes of diffusion, however, may also entail taking significant risks:

> "Once we got the process going with the product managers of the banks, (the sub minister) coordinated meetings between the minister of the economy and the CEOs of NAFIN and the banks. In those meetings, the minister asked for their cooperation and commitment with the SME issue. He offered them the SE's commitment that all programs would be designed in conjunction with them, but in exchange he demanded their willingness to commit to results and to an open process. Once those top officials agreed, the sub-minister repeated a very ballsy move over and over: even before the programs were designed, before we had any idea of what exactly it was we would do, before we even had signed agreements with the banks, he made *very* public announcements of the new "national guarantee system" and the banks that would participate in it. In every public event he had, he would make an additional announcement. If a representative of any of the banks was present, he would "recognize" the institution as a pioneer in the SME program. Every time a bank achieved any positive result, we (the SE) would make sure to promote it through the press, and the Secretary would give yearly awards which were highly publicized. He also made public announcements saying that NAFIN was a leader in the process, even though it wasn't really. These strategies were sometimes not very popular with NAFIN and the banks, but it forced them to move quicker than they felt comfortable doing, and put them on the spot to really fulfill their promises. It generated a lot of public pressure on the CEOs, who in turn pushed that pressure down to middle management."

For the SINAFIN program, public diffusion of results through the press generated two important effects. First, it fueled competition between the participating banks and it forced banks that had not been interested in the program to revisit the issue. In the words of a state government official:

> "If I want a bank manager to call me, all I have to do is talk to a reporter about the great results that his competitor has achieved. I guarantee you I get a call within the next day."

Or, from a bank manager's perspective:

> "We very recently launched our new SME product. I have to be honest with you, I don't have much faith in it for the same reasons I didn't have faith in it three years ago when the SE first approached us. The fact of the matter is, our main priority is to keep our depositors, because we make most of our money from the commissions we charge. What is beginning to happen, however, is that some of our depositors are taking their business to other banks because they are offered a loan. If we want to keep them, we must offer them an equally competitive alternative. For us, the loan product only seeks to retain existing customers, and we will be very careful to not engage in any risks."

Second, and equally important, it sent a message to business owners that bank credit was now a viable option for them:

> "The reason I approached a bank to learn more about these SME loans was because I read an article in the newspaper. It said that the (state) minister of the economy had given (bank name) a prize for placing a thousand loans to SMEs in the state. My first thought was that they must have been larger businesses that were friends with the governor and I didn't really think I could apply for a loan. But I kept the article (after shuffling through some papers he showed the clipping to me) and I started to ask around. By then I had already heard some radio commercials about SME loans from two banks, but I just didn't know what they meant by SME and if I was big enough for them. In a later article they showed the picture of one of the businesses that got a loan, which was a small office supplies store. When I saw that I thought: 'My business is better than that!' and I went to the bank branch around the corner."

As one state minister of the economy succinctly put it:

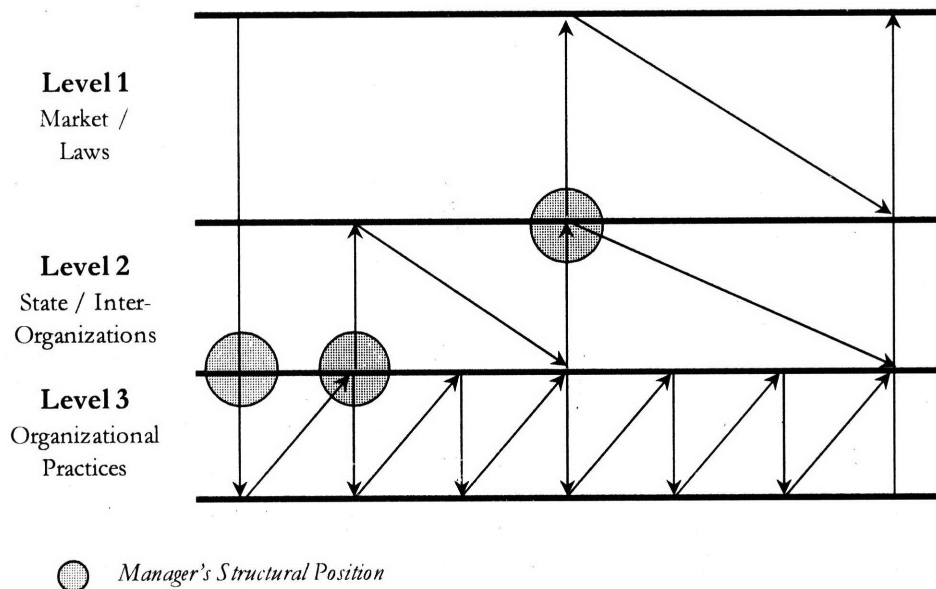
> "Pa' que nazca este pollito no es suficiente poner el huevo, ¡también hay que cacarearlo!"[16]

Note, then, that middle-managers' structural position is crucial in the process of institutionalization of new practices. Previous studies of processes of institutionalization have described how structuration gradually shapes new practices until they become institutionalized (Giddens 1984). That is, they show how a change occurring one level above an organization and exogenous to it is introduced and how it shapes new practices (Barley 1986; Sutton et al. 1994; Orlikowski 2000). They also show how the new practices that develop within the organization can feed back up and transform broader

[16] "If you want this chick to hatch, it is not enough to lay the egg… you also have to cluck about it!"

institutions (Edelman 1992; Edelman et al. 1999). What is not yet clear, however, is exactly how exogenous changes enter the organization and, more importantly, how it is that organizational practices "climb up" an additional level to become more broadly institutionalized. In the incorporation of title VII legislation into organizations, for example, the fact that it was the personnel profession (HR managers) within certain organizations that first promoted it –partly as a way to increase their status and power within those organization—had a profound effect not only in how the legislation was interpreted and how it shaped organizational practices but also how those practices later shaped the legislation itself (Edelman et al. 1999). If we think of organizations as systems embedded within a multi-layer institutional structure, then we can see how institutionalization happens at (at least) three different levels; going from within-organizational practices (level 1), to "common" organizational practices, to market-level norms and regulations. Middle managers, as I have shown, are structurally placed in the intersections between these different levels and, as such, are instrumental in transferring practices across them (see figure 7).

Figure 7.- A Multi-Level Process of Structuration



Conclusion

On many levels, the SINAFIN was a remarkably successful program. To begin with, it allowed hundreds of thousands of SMEs to access bank loans that they would have otherwise not received. The actual results of the program show that it was indeed SMEs that had previously not had access to bank credit who received the bulk of the loans. They mostly used them to substitute less efficient sources of working capital, such as trade credit or personal credit cards. Repayment rates exceeded even the most optimistic predictions, and all of the goals set by the SE administration were surpassed by large margins. By 2006 there were more than twenty-five different credit options for SMEs where there used to be none, some provided by banks and others by a new generation of financial intermediaries that emerged with an SME-specific focus. That said, there is evidence that there is still significant room for improvement. While some loans were used to finance fixed asset investments, this represented a much smaller portion of the total. In fact, there is some evidence that in 2006 most banks were still very cautious in their lending, providing smaller amounts than the SMEs required which in some cases even led to inefficient outcomes.[17] Loan application processes are still cumbersome and many firms are rejected due to system inefficiencies not linked with their credit worthiness.[18] While it is true that all of the major banks are now specifically addressing the segment, there remains a massive unmet demand in a population of millions of SMEs.

It is difficult to predict what will happen with the SME credit market in Mexico. Most of the players engaged in it are still in the definitional stages of their processes and have yet to define their full market strategy. What is clear, however, is that many of the changes occurred at a structural level and are hard to reverse. Not a single one of the bank managers I interviewed believed that their organization would stop exploring the SME

[17] For example, there is evidence of cases where an SME requested a loan to invest in a fixed asset an received less than it required, which meant that the company was indebted but was not able to generate the incremental income it had expected from the investment, which in some cases led to a default (and to a false reaffirmation that the bigger loan should not have been granted)

[18] A current requisite to access a loan is to have a clean credit record. However, the credit bureau in Mexico is still underdeveloped. Many small firms don't have a credit history and are thus denied a loan. Others have faults in their credit record due to name confusions. Others still have poor credit records due to non-payment of services they never contracted By a manager's estimate, around 50-60% of rejections should be re-evaluated.

market if the guarantee program stopped. Either because they "discovered" a segment they didn't know existed, or because they need to keep up with the competition, all existing banks are exploring SME credit products. The fact that three of the largest banks redefined their long-term strategy around SMEs is another telling sign.[19] At a broader level, significant legislation reforms have been passed both to facilitate the banks' lending activity and to promote the entrance of new competition into the segment. While the end point of this change process is unclear, it will certainly be quite different from the situation in 2000, where much was ignored and unquestioned around SME financing.

The SINAFIN provides helpful insights into the mechanisms of institutional entrepreneurship both because of the broad change it generated and the central role that individuals had in designing, launching, and implementing it. Neither the features of the program nor its levels of success can be understood without looking at the individuals engaged in its creation. At the same time, what emerges from the analysis is far from a heroic view of institutional entrepreneurship, where a single or few actors are attributed all the credit. First, while the case highlights the role of individuals, it also highlights that there were actually many actors trying to promote change with varying levels of success. It also shows how institutional entrepreneurs could not act in isolation but needed to coordinate efforts across organizations and geographies to achieve change, which results in a "distributed" view of institutional entrepreneurship (Lounsbury and Crumley 2007). Second, even though the individuals that drove the change were doing so purposefully, they were mostly reacting to the strain generated by their organizational roles, which defined broad goals but did not provide clear means to attain them. In some cases, such strain was combined with a professional background that provided a broader set of cultural tools and the ability to envision an opportunity for institutional change. The motivation for change was therefore much more to "do a good job" than to heroically transform the country. Third and maybe in consequence, these institutional entrepreneurs were more often than not the casualties of their own change processes.[20] Within the SE, for example, three of the government officials that were most influential in the design of

[19] One of them, for example, changed its market slogan to become "the SME bank".
[20] A similar finding is reported in Burgelman's papers, see note 29 above

SINAFIN became the casualties of its success. In one case, as I detailed above, the official was moved to another job by presidential orders.[21] In another case, the official was forced to quit due to political pressures once the program began drawing political attention for its success and other SE officials tried to appropriate the political benefits. A similar pattern was observed in other organizations. For example, Adrian, who was arguably the most influential private sector participant in SINAFIN, was driven out of his bank by higher-level managers fighting to bring the product to their areas.[22]

The lack of heroism, however, does not make the change less purposeful. The fact remains that the different actors initiated the change with full intention, and SINAFIN is an illustrative case of how institutions can be endogenously changed. More importantly, it shows how this type of endogenous, purposeful change can be a natural consequence of institutional dynamics, and how it can be envisioned and fostered by actors within a system. These findings have several theoretical and policy implications, which are discussed in more depth in the concluding chapter of this dissertation.

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[21] Incidentally, Jaime recalled this as the most painful event in his professional life. "I had invested so much time, effort, and political capital into this project that I was crushed to leave it just as it was beginning to take form."

[22] After leaving the bank, Adrian was in the process of creating a small, SME-specific financial intermediary.

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Chapter 5

Weaving Straw into Gold:

Enhancing Microcredit Impact through Personal Involvement

Previous chapters discussed the need to explore the mechanisms through which individuals shape and eventually change institutions. In particular, Chapters 3 and 4 used the creation of the small business credit market in Mexico to show how institutional entrepreneurs detect opportunities for change, as well as how their personal and structural characteristics interact to determine whether their change efforts will succeed. A central tenet of these chapters is the notion that, given that unobserved divergences may exist between the public beliefs that converge in institutionalized settings and the private beliefs of the individuals embedded in them, a relatively large pool of potential institutional entrepreneurs could habitually be present within an institution. The chapters use this notion to support the empirical observation that, in fact, a much larger number of institutional entrepreneurs could be observed in the creation of this market than the existing literature would predict. What the chapters do not show, however, is how conflicting institutional logics –or diverging private beliefs—actually coexist, how they are maintained, and how they affect organizational practices when they are not used in an overt attempt at change. The present chapter addresses these issues by bringing the level of analysis down to explore the question *within* organizations. The chapter analyzes three microfinance organizations in Mexico (MFIs) to show how the practices of certain individuals routinely diverge from formally sanctioned rules, how these –often conflicting—diverging practices can lastingly coexist with standard practices and how, when they are successful, they can end up transforming the formal rules.

Introduction

The drastic expansion of microfinance across all corners of the world has predictably been matched by an equally dramatic display of research efforts to understand it.[1] Much effort has been made in recent years to understand both the impact that microfinance programs have on their clients and which particular programs are better at achieving their objectives. Analyses mostly focus the structural design features of microfinance institutions (MFIs), and whether certain contractual structures are better at impacting family incomes, women empowerment, income instability, health standards, capabilities, business practices and social capital through the provision of microloans. Through the

[1] In 2005 alone, microfinance institutions (MFIs) around the world issued more than 100 million loans placing more than $30 Billion in credit.

evolution of this literature, an "orthodox" view has emerged that focuses on the mechanisms through which certain contractual structures create better incentive alignment and should therefore produce better and steadier impacts. This orthodox view can be found in numerous "best practices" documents that are transferred to MFIs through donor and development agency networks. At the same time, and given the vastness of the literature, it is surprising to find a significant degree of dissent around several of the most basic questions, like whether MFIs truly have positive impacts on their clients or the specific mechanisms that determine those impacts (Morduch and Armendariz de Aghion 2005). It is also puzzling to find large numbers of MFIs around the world that are successful even though they diverge from standard practices, as well as programs that have mirrored those practices to the letter but have nonetheless failed.

A basic presumption of best practices that center on contractual structures is the notion that lending decisions, loan structures, and organizational practices should be founded on universalistic (as opposed to particularistic) factors. That is, they presume that lending should be done strictly based on "objective", measureable factors that can be statistically controlled rather than on "soft" information that can only be obtained through social ties. The basic premise behind contractual approaches is that they provide much better frameworks to align the incentives of all those involved –meaning clients, loan officers, and the bank principals. A second, and related, premise is that the focus on formal, easily enforceable structures can avoid corrupt practices and reduce variance in the outcomes of lending relationships by using stable, transparent, and verifiable metrics (c.f. Hart 1995). These premises greatly shape how scholarship analyzes credit relationships, the conclusions and recommendations that emerge from them, the "best practices" that are disseminated and, as a result, the actual practices and structures of lending organizations. However, there are at least two factors that cast doubt on this approach, especially for small business lending and even more so for microlending.

The first is that, on the one hand, there is increasing evidence that no financial market operates solely based on contractual structures (c.f. Uzzi 1999; Davis 2004). On the other hand, "soft" information that requires personal ties for its transmission is especially

important for small firm lending (Berger et al. 2001; Berger and Udell 2002). The second has to do with the more fundamental question of whether discretion in lending decisions *can* be avoided or, put differently, whether a lending relationship can ever be fully sanctioned by a contract. In most types of business lending, but more so in microcredit, most –if not all—the interactions between clients and firms happen at a decentralized level, through branch managers and especially loan officers. Loan officers, for their part, work with inadequate resources, in circumstances where demand will usually surpass the supply of services, with significant constraints on the types of actions available to them, and facing a large amount of variance and uncertainty in the situations they must decide upon. Interestingly, these conditions mirror quite closely what Michael Lipsky describes as "Street-Level Bureaucracies". When the nature of work is such that it must be done under these conditions, Lipsky has shown, employees must be granted large degrees of discretion in the utilization of resources, the management of particular interactions, and the application of rules. Accordingly, no set of rules can possibly predict or sanction all interactions (Lipsky 1980).

Despite all this, the most cited works in microfinance place an overwhelming emphasis on structural features of the programs as determinants of performance and have, for the most part, neglected the role of managerial and loan officer practices. In reaction, new work is emerging that shows how organizational and managerial practices are the true determinants of outcomes (Jain and Moore 2003). This new work, however, also focuses mostly on formal rules and structure s at the organizational level. However, loan officers are the key point of contact (often the only one) between MFIs and their clients. They are in fact the relationship, financial, and information brokers between the two. It is in their daily interaction with clients that company policies are enacted, loans are granted and collected, and client information is transferred. Given the ambiguity that surrounds their work, loan officers must have a great degree of discretion to make decisions on the spot. During each interaction with their clients, loan officers must interpret centralized rules and policies and decide whether and how to implement them (Wilson 1968; Lipsky 1980). For the most part, however, the existing literature has neglected their role and has assumed that rules and structures are translated directly into organizational outcomes.

This chapter sheds light on the mechanisms through which loan officers impact not only the performance of MFIs but also their very rules and structures. I will show that manager and loan officer practices –above and beyond structural design features of MFIs such as lending methodologies, contract structures, or operational rules and procedures—may account for better performance and profitability. This is because there is such variability in the specific situations that loan officers face when interacting with clients, that no set of rules could possibly predict all of them. As a result, some loan officers learn to think of rules and contractual structures as tools that they can strategically use in the fulfillment of their jobs; rather than try to follow them closely in situations where the "right" application of the rule may not be clear. I will show that, based on a close understanding of their clients, certain loan officers and branch managers strategically bend the rules to better fit their clients' needs. In so doing, they have managed to reduce delinquency rates, increase loan renewal rates, and avoid potential negative impacts for their clients. In addition they mitigate the clients' inherent vulnerability by providing additional support to poor clients at times of need. I will argue that this is of particular importance given that poorer people find it harder to benefit from a microloan due to their increased vulnerability to external shocks.

The chapter is structured as follows: I will first provide a brief review of the relevant literature. Second, I will describe the data and the methods I used for this chapter. In the third section I will discuss the different types of loan officers I encountered in my research, explaining the particular ways in which their behavior differs and why this is important. Later I will discuss the issue of how microloans impact the poorest of the poor to then show how loan officers are a key aspect of microfinance.

Performance of Microcredit Programs

Given the universality and popularity of the microfinance phenomenon, there is a widespread literature on the impacts and characteristics of Microfinance Programs or Institutions (MFIs) and literally hundreds of papers and books have been published on the subject (Armendariz de Aghion and Morduch 2004). So far, most of the literature has focused on understanding the apparent paradox of microcredit: individuals that are poor

and mostly uneducated, have no credit history, do not own any form of collateral to guarantee a loan, and for the most part have never been exposed to financial services display remarkably healthy borrowing behavior. Moreover, microcredit is increasingly seen as an instrumental tool in the battle against poverty, as borrowers seem to benefit disproportionately from the productive investments they make with these small loans (Khandker 1998a; 2003). Most studies have focused on programs in Bangladesh, India, South East Asia and Bolivia. In general, they conclude that microfinance programs have a positive impact on poverty levels through the promotion of micro-entrepreneurial activities, reductions of income instability, increases in women empowerment, improvement in school attendance rates, changes in health habits, and decreases in birth rates among other things. That said, and considering the vast amount of works that explore the topic, it is surprising to find a relatively large degree of discrepancy both in the impacts of microfinance and, more specifically, in the mechanisms that determine those impacts (Morduch and Armendariz de Aghion 2005).

The majority of the studies have focused on the contractual and structural aspects of microloans, and numerous views on the determinants of MFI success have emerged. There are the "orthodox" views that see success as deriving entirely from the contractual structure of the loans. High repayment rates are, for example, due to the creation of "social collateral" through borrowing groups (individual borrowers repay because of strong socially-constructed collective responsibility at the level of a group); to the commitment that results from borrower participation (there are strong participatory elements as microcredit promotes the involvement of borrowers in company decisions); and increasing commitments (authorized loan amounts increase with loan repayments and clients value the access to future loans) (Morduch and Armendariz de Aghion 2005). As I mentioned above, while these orthodox views have received much attention and can be found in numerous "best practices" documents, they fail to account for the large numbers of MFIs around the world that are successful even though they diverge from standard practices; or for the failures of programs that pretty much mirror standardized practice in their structural design but nonetheless fail. In addition, the sheer diversity of contractual structures adopted by (successful) MFIs around the world seems to indicate that there are

additional mechanisms operating in their success, and that contracts do not provide a full explanation.

There is an additional methodological concern. Most of these impact studies perform statistical analyses on MFIs' data, which presents problems on two levels. The first is that most MFIs have (at best) precarious databases that are difficult to work with and additional data has to be gathered on a very ad-hoc basis (Armendariz de Aghion and Morduch 2004). The second is that the analyses are inherently methodologically complex, as they presuppose having a control group to determine whether the observed benefits are truly attributable to the program itself or to other environmental effects; but it is very difficult (especially ex-post) to build a truly representative, usable control group (Winship and Morgan 1999; Winship and Sobel 2001). Even when control groups are found, selection issues remain, as there may be something inherent in people that either self-select or are selected into a program that could be driving the performance differential (Pitt et al. 1999; Hulme 2000; Zaman 2001; Khandker 2003). These methodological difficulties account for much of the discrepancy in the findings reached by the existing literature, where explanatory emphasis is often placed on different structural aspects of the MFIs, ranging from their lending methodology (communal vs. group vs. individual), to their collection procedures, to their gender focus (Armendariz de Aghion and Morduch 2004).

As a reaction to orthodox –yet inconclusive—explanations, there is a revised view that claims that more successful MFIs simply have better managerial practices. That is, they present narrow and standardized service offerings, policies that match loans to existing –not potential—borrower payment capacity, loan products that target specific client needs and are pro-cyclical, social as well as contractual pressures to repay, and adequate personnel management and motivation practices that include well-aligned incentive schemes (Jain and Moore 2003). In their chapter, Jain and Moore place much more importance on sound, business-oriented organizational practices as determinants of success than on particular program design features such as group or individual lending methodologies. While they convincingly question orthodox accounts in the defense of

organizational practices, they also place the emphasis on the structural aspects of the programs, as well as on the written rules and procedures, and not in how the rules and policies are actually implemented.

That is, in both of these explanatory strands there is an implicit assumption that stated rules and policies are followed to the letter, despite evidence that this is not necessarily the case (Gouldner 1954; Wilson 1968; Lipsky 1980). In consequence, and even though all the interactions between MFIs and clients happen at the loan officer level, most studies use the entire organization as their level of analysis while neglecting field-level practices and interactions. Partly as a result of this, in even the most methodologically rigorous papers the mechanisms that explain the reported statistical relationships tend to be vaguely defined and are difficult to corroborate. Accordingly, they focus more on describing the phenomena than on explaining them. That is, they focus more on showing the *"what"* than on explaining the *"why"* of their findings. The lack of focus on actual mechanisms and the high level of analysis may help explain the lack of consensus in the determinants of success. It could also account for the remaining puzzle of why programs that follow similar structures, policies, and rules perform so differently. More importantly, if the nature of microcredit is such that formal rules are decoupled from actual practices, which in turn shape future rules; then only analyzing present rules would both miss the large potential variance contained in diverging (actual) practices, as well as ignore the endogenous causal link between current decoupled practices and future rules.

To address these issues, this chapter uses a mixed-method research strategy, complementing qualitative with quantitative evidence. Specifically, it explores the interaction between loan officers and clients, to better understand the mechanisms and inner-workings of a microloan. In microfinance, loan officers usually represent the sole point of contact between clients and MFIs and their discretionary actions determine the access that a potential client will have to a loan as well as its conditions. MFIs are inherently labor-intensive and labor-dependent, as they provide their services through loan officers that access and monitor a great number of atomized, small-scale clients (Morduch and Armendariz de Aghion 2005). The poorer and more excluded a client is,

the more she will depend on a loan officer to find her and grant her access to a lending opportunity and therefore, the more impact that all of the loan officer's decisions will have on her life. Loan officers make decisions every day that truly affect their clients' life chances. Moreover, they have to manage the clients' reactions to their decisions and therefore they must operate on a constantly shifting ground. While the major dimensions of their work –such as lending policies, incentive schemes, and collection rules—are structurally defined, they work in situations that often require responses on dimensions that can simply not be contemplated by formal rules –such as gauging the moral character of a potential client who has no financial records. The nature of their decisions calls for a higher level of discretion based on critical and sensitive observation and judgment.

As I introduced in Chapter 2 of this dissertation, Mexico is a particularly fertile ground to study these issues for several reasons. First, the Mexican microcredit movement is estimated to have emerged with a ten year lag in comparison to other Latin American countries for several historical reasons detailed in Chapter 2 (Christen 2000). As a result, a relatively narrow set of international best practices had already emerged and there were quite specific expectations of what a legitimate MFI should look like, what lending structures it could use, and what its objectives should be. Second, the financial crisis of the mid 90s greatly affected both liquidity levels in Mexico and national investors' confidence. As a result, emerging Mexican MFIs were especially dependent on foreign donors and therefore experienced additional pressure to conform to international expectations and to comply with institutionalized forms. Third, the large amount of market and regulatory uncertainty that these MFIs encountered created a strong discrepancy between donors' expectations, formal rules and goals, and actual market conditions and organizational needs (Alpizar and Gonzalez-Vega 2006). This discrepancy put in full relief the existing contradictions that exist in all MFIs but that became dramatically salient in the Mexican case. Fourth, given the relatively high market concentration, it is easy to identify market leaders and the most established players who are at the forefront of the market and who set the pace –and the normative example—for other emerging MFIs.

In Mexican MFIs, and similar to Lipsky's Street-Level Bureaucrats, loan officers work with chronically inadequate resources, with expectations from their employer that are often ambiguous or even conflicting (e.g. profitability vs. poverty reduction), with a demand that greatly exceeds the supply of services and therefore constantly places them at the border of their capabilities and resources, and with performance measures that are difficult (arguably impossible) to define and quantify. In such settings, Lipsky argues, employees must exercise a great amount of discretion, since a large number of decisions have to be made on the spot, with few resources, and with very ambiguous information. As a result, managers knowingly grant discretion to their subordinates and often "turn a blind eye" to instances of rule bending (Lipsky 1980). Given the similarities in the nature of work between the agencies that Lipsky describes and MFIs, it is surprising to find such little reference to loan officers and their practices. If loan officers inherently have such levels of discretion and power over the outcomes of loans, then understanding how the relationship between clients and officers play out on a daily basis and how that affects the performance and structural aspects of MFIs seems necessary.

Data and Methods

I performed a mixed-method analysis of three MFIs in Mexico to untangle the relationship that clients have with MFIs, and the impact that loans can have on their life. Given the complexity of the phenomenon, I place particular emphasis on qualitative methodologies, following a grounded theory building approach. I also explicitly straddle different levels of analysis, going from organization-wide rules and policies, to branch managers, to actual interactions between loan officers and clients.

Given that the chapter explores how field-level practices affect lending outcomes, the research design seeks to first understand within-firm variation, or the mechanisms that explain differentials in performance across branches of the same MFI, to later look for patterns of those mechanisms across different MFIs. Accordingly, the basic choice of organizations was made to learn more about the particular professional and managerial practices that develop in the MFIs, how those practices depend on and influence structural design features, and how they relate to MFI performance and socioeconomic impact. I therefore worked with one company (FC) that works mainly in the urban sector

mostly with an individual lending methodology,[2] another company (FR) that works mostly in rural sectors with a communal methodology, and a third (CG) that works both in the rural and urban sectors and that mixes group and communal lending (see table. 1). I picked these companies because, even though they have different program structures and lending methodologies, they are all profitable, they have been so from their origins, they have all been recognized by international NGOs and association as following "orthodox" best practices, and they are all growing aggressively. The mixture of companies allows for the comparison between individual and group lending methodologies, as well as the practices that develop inside each of them. This is important because many of the arguments about microfinance have been made around such contractual structures. Similarly, they contrast differences between urban and rural environments, as some of the arguments that have been made, particularly concerning social capital explanations for performance, have been based on rural vs. urban contexts. The focus was therefore on using within-firm variation to disentangle the mechanisms that drive loan behavior to later detect whether those same mechanisms traveled equally well across different lending structures.

While the lending methodologies vary considerably between the three companies, there are also some similarities: all companies have a lending system that gradually increases loan amounts as clients demonstrate their ability to pay, or dynamic incentives (Jain and Moore 2003); all companies are organized following a similar central office-regional office-branch structure; they all have relatively similar compensation schemes for their loan officers that are variable and based on business metrics (number and amount of new loans, loan renewals and delinquency rates –more on this later); all companies have

[2] There are three basic lending methodologies in microcredit: communal banks, solidary groups, and individual loans. Communal banks are by far the most widespread of the three and were promoted by the inventor of microfinance and founder of the Grameen Bank in Bangladesh, Muhammad Yunus. The idea here is that groups of at least twenty and as many as around fifty clients come together and collectively request a loan. They are self-regulating and self-enforcing and they are all collectively responsible for the repayment of the loan, even though the loans are distributed individually inside the group. Solidary groups are much smaller groups (from three to five, sometimes a few more) and are also collectively responsible for the loans but the loans are given directly to the individuals as opposed to the group, and groups are not self-regulating. The interaction between the bank and the client is not, as in solidary groups, at the group level but at the individual level, nonetheless the group is used as "social collateral" for the loan. Individual loans are self explanatory.

clearly defined business practices around conditions and metrics for lending and collecting while placing most of the discretion on final lending decisions on the loan officers themselves; and all of them show a strong commitment to the poor, both through their external communications and in their internal processes. In addition, as I mentioned above, their lending and business practices have evolved in a very similar fashion to the "orthodox" accounts of microfinance (Hulme and Mosley 1996; Khandker 1998a; Yunus 1998; Pretes 2002).

I spent a total of five months collecting qualitative data with these companies. A majority of that time was spent within FC (around 60% of my total time), where the initial findings emerged. I later repeated the methodology extensively with FR (about 30% of my time). Finally, CG was used as a validation case (the remaining 10% of the time).

Table 1 – Lending Methodologies and Geographic Focus by Company

	Lending Methodology			*Geographic Focus*	
	Communal Banks	**Solidary Groups**	**Individual Loans**	**Urban**	**Rural**
FC	No	Yes	Yes	Yes	No
FR	Yes	No	No	Yes (some)	Yes
CG	Yes	Yes	No	Yes	Yes

Note: Shaded area represents main focus of this study.

I divided the qualitative part of my work in two phases within each company. In the first phase I interviewed MFI employees, starting with the CEOs and slowly working my way down the organization until I reached the loan officer level. To pick the branch managers and loan officers I interviewed, I asked my employee interviewees to place branches in three groups: the good performers, the average performers, and the poor performers. The categorization was highly consistent across employees in each of the companies, and I corroborated it with company reports. I then randomly selected one or two of the branches from each group for each of the companies. Once I reached the branches, I spent between half a day and a whole day visiting the branch, talking to the manager, attending committee meetings and sitting in on manager-client and manager-loan officer

interactions. Subsequently, at the end of the branch visit the sample of loan officers was picked at random, during an interview with the branch manager.

I spent an entire day, in some cases two days, with each of the officers, shadowing them on their route as an observer to learn how they interacted with clients, observing their lending and collecting methodologies, and asking the loan officers to narrate their actions after they had occurred. In this first phase I interviewed a total of 43 employees from the different companies. In the second phase of the study, I performed client interviews. To pick the interviewees I asked the officers to give me a list of their clients and I randomly selected four or five. I also asked officers to select for me one of their best clients and one of their worst clients to ensure variation. Moreover, I asked each officer to lead me to some program drop-outs; that is, clients who were no longer in the system. This is important because a shortcoming with existing studies is that in MFIs' databases, clients who drop out are censored and it is impossible to determine whether a client dropped because she "graduated" out of microcredit, because she decided she did not want an additional loan, or because she experienced difficulties and was kicked out. This censoring is potentially significant, as it might grossly underestimate negative impacts of loans and only measure results on the clients who have chosen to stay in the program. In total, I performed just over 50 client interviews.

As a complement to my qualitative work, I performed several analyses using FCs panel database which has information on each of its clients. They gather information on family income, type and quality of housing arrangements, available services, family characteristics (number, age and education of children) and several other socioeconomic indicators. This information is gathered when clients apply for a first loan, when they renew their loan for the first and second times (that is, before the second and third loans) and then every two loans or every time a significant loan increase (higher than 30%) is requested. As a result, it is a database covering thousands of clients over several years with the program and several records per client per year. Interestingly, they have kept records of clients who have applied for a loan but have nevertheless not received it. In

most of those cases, the loan was not rejected, rather, the client decided not to take it after it had been approved.

Results

If structural characteristics are the sole determinants of performance and socioeconomic impact of a MFI, then we would expect entities that have similar structures and that are situated in similar environments to show little variation between them. More specifically, we would expect that similarly situated branches *within* the same program would show similar results, as they are exposed to very similar environments and they operate with the exact same structure. However, this is not what we find in practice. In fact, there are stark differences between branches within each of the programs on all performance metrics which would be difficult to explain solely with a structural approach. Table 2 shows some key metrics for a sample of branches of FC. As it can be seen, there is a significant level of variation between branches in the key metrics that FC uses to measure performance: growth in loaned amounts and delinquency rates. At the same time, the most evident structural explanations for that variation don't seem to hold.

A first natural reaction would be to say that certain branches are situated in a wealthier region, where clients can better afford to repay loans. The evidence does not support this on two accounts. First, there is not a large difference between the mean or median incomes of clients across branches. Second and more importantly, the relationship between income and performance seems to point in the opposite direction. The best performing branches such as branch 26 or 32 seem to have the lowest levels of both mean and median income and indeed the correlations between income and performance also point in the opposite direction than common sense would predict. A second structural explanation might argue that there is something about a particular region that simply makes clients in it better payers –maybe there is a better "payment culture." Again, the evidence does not support this claim. Some of the starkest differences can be seen between branches such as 25 and 26, or 31 and 32 that are actually situated in very close proximity to each other with substantial overlap in their coverage areas. Competitive dynamics, which could also be used as explanations, would be hard to sustain given that

demand for FC's services in all its covering areas –and indeed demand for microfinance in general—has so far exceeded the existing supply.[3]

Table 2–Some Key Metrics by Branch (FC)[§]

Branch	Delinquency Rate (amount)[2]	Delinquency Rate (loans)[1]	Growth[3]	Mean Monthly HH Income	Median HH Income	Std Dev of HH Income
24	3.48%	10.10%	9.20%	2,200	1,704	1,651
22	4.05%	10.40%	11.20%	2,542	1,827	2,084
32	5.16%	5.16%	14.40%	2,089	1,597	1,280
41	5.52%	11.70%	4.60%	2,070	1,590	1,419
42	5.93%	15.00%	11.70%	2,145	1,678	1,507
61	6.38%	10.50%	10.30%	2,105	1,589	1,527
21	7.14%	17.90%	6.00%	2,496	1,804	2,229
31	7.82%	17.80%	3.30%	2,583	2,156	1,603
26	7.90%	7.90%	8.00%	2,050	1,530	1,409
43	8.14%	17.40%	-0.90%	2,268	1,833	1,574
52	8.57%	19.70%	-7.10%	2,287	1,844	1,748
51	8.68%	20.70%	10.70%	2,314	1,724	1,873
25	10.00%	19.10%	0.80%	2,362	1,641	2,470
11	10.35%	22.40%	6.20%	2,315	1,720	1,777
Overall	**16.31%**	**7.51%**	**1.5%**	**2,342**	**1,768**	**1,799**

Correlations	Mean Income & Delinquency	STD Income & Delinquency	Median Income & Delinquency	Mean Income & Growth
	0.19	0.30	0.26	-0.24

[§] Only a selection of branches shown –representative sample of branches, selected based on branch performance and geography
[1] Measured as % of loans –These figures may seem high compared to international standards. It is noteworthy that they refer to two-week delinquencies, vs. the standard view of one month
[2] Measured as % of total amount lent by branch
[3] Measured as average monthly increase in total amount lent by branch

[3] Competition has more recently started to become a factor in Mexican microfinance, as more programs arise and existing ones continue growing. All my interviewees agree, however, that up to 2004 competition had not been an issue for any of their branches.

Within-firm variation can also be seen in the impact that loans have on clients. During my interviews, most MFI employees (around 70%) mentioned how poorer people often weren't able to take advantage of the loans as much as the middle poor, who in turn benefit more than the non-poor. The operations manager of one of the companies summarized it particularly well:

> "For some people, the loans, especially the first ones, are productive beyond belief. For people who have an established business, for example, regardless of how small it is, if the limit to their sales is the amount of working capital they have which is, let's say, US$500, and you suddenly increase that amount by $100, you just increased their sales by 20% in one day! You need a certain level of stability and infrastructure to be able to make and manage those investments though. The poorer you are, the less likely you will be to have those basic conditions and the harder it will be for you to make productive investments on a consistent basis (...) Likewise, once a client's business reaches a certain level, loans stop being as productive. Once the working capital limitation is removed, it is the clients' educational and environmental limitations that stop them from truly breaking through."

This is a counter-intuitive finding; first because microfinance programs are supposed to be designed to help the poorest; second because poorer people who start from a smaller economic base should be able to increase that base much more and much easier in percentage terms than people who are working on similar things and that start from a higher base. The same manager, however, explained why this paradox exists:

> "Giving financial services doesn't necessarily help people. It helps some people but it leaves some people unaffected and it negatively affects some others. Sometimes it does more harm than good. Poorer people have many problems beyond the lack of access to financial services. When you fix one of their issues by lending them money, they still have many other problems to deal with which are not solved by a loan. Sure, some people use the loans as a springboard, but you can't really use a springboard when it is under water, you know?"

Interviewees constantly referred to the structural barriers that poorer people had to overcome above and beyond the lack of access to working capital and that made it more difficult for them to benefit from loans. To test these findings, I performed a series of statistical analyses on FC's database and I found that, on average, the benefit derived by a client from a microloan is not dependent on initial endowments. That said, there is evidence that clients –and especially poorer clients—benefit much less from a loan in certain branches than in others. Table 3 shows, for the same sample of branches, average

increase in household income for credit recipients. It shows both the average increase for the totality of clients and for those clients below the median of initial income.[4] It can be seen that, on average, clients tend to perceive considerable increases in household income after receiving a loan,[5] and poorer clients tend to experience even larger increases. However, in certain branches (11, 32, 51 and 61) clients show significantly smaller increases, especially the poorer ones. At the same time, in certain branches (26, 24) clients seem to have experienced significantly higher income increases. These findings are consistent with the fact that, often, when asked the broad question of how the MFI impacted its clients, interviewees referred to particular branches where poorer clients had been impacted in a more positive way and others where the poor were constantly in trouble. It is interesting to note that the branch with the income increases was commonly mentioned as a high performer in my interviews (in more than 50% of the cases) and appears so by standard metrics (look at branch 26 in figure 2), while one of the branches with negative coefficients was mentioned as the poorest performer (in 80% of the interviews) and also appears so by standard metrics (branch 51 in figure 2).

[4] The median income was calculated on the totality of FC's clients, not on a per branch basis, to keep a steady comparison between branches.

[5] It is important to note that I am not claiming that this income increase is *because* of the loan. I do not intend to engage in a discussion about whether loans have an impact, which would be impossible given that I am only showing increases for *credit recipients* (I am not showing a comparable control group) and I am not modeling a selection function. That said, two comments are worth making. The first is that, given that I am focusing on *within firm* effects, it is informative to compare credit recipients across branches – especially for the below-median group—given that credit policies are defined centrally. The second is that I could not compare credit recipients against a control group at each branch given that the size of FC's control group was too small to cover all branches. It is still informative to show that, on average, non-recipients had lower income increases than recipients. This (relatively small) control group was formed by people who had an initial diagnostic made but were not given loans and were later subject to an additional diagnostic. For these non-clients we therefore have all the same metrics as we do for clients in at least two points in time but we also know that they did not have a loan. There are two main reasons why they were not given loans. First, some of them voluntarily declined the loans for a variety of reasons –were skeptical, did not want to incur in debt, were convinced otherwise by their spouse, etc.—and second, some of them were denied the loans. I understand that it is potentially very problematic to use this group as a control given that much of the difference between them and people with loans could be explained by the selection function. Moreover, comparing the control group to the treatment group shows no significant difference in the observable variables.

Table 3–Increase in Household Income, Credit Recipients

Branch		**Mean Increase (%)**	**Difference in Means**+
11	Average	0.027603	**-0.1087231****
	P50¥	0.015687	**-0.1569855****
21	Average	0.111541	-0.0247852
	P50	0.08342	**-0.0892525****
22	Average	0.150398	0.014072
	P50	0.218379	0.0457065
24	Average	0.201216	**0.0648905****
	P50	0.258333	**0.0856602****
25	Average	0.160307	0.0239812
	P50	0.220932	0.0482595
26	Average	0.203587	**0.0672611****
	P50	0.240868	0.0681949
31	Average	0.151646	0.0153204
	P50	0.234256	0.0615829
32	Average	0.060982	-0.0753439
	P50	0.059627	**-0.1130453****
41	Average	0.088681	-0.0476449
	P50	0.142197	-0.0304758
42	Average	0.110925	-0.025401
	P50	0.161011	-0.0116618
46	Average	0.007177	-0.1291488
	P50	0.063995	-0.108678
51	Average	0.054289	**-0.0820365****
	P50	0.022527	**-0.1501453****
52	Average	0.196436	0.0601106
	P50	0.558491	0.385818
61	Average	0.018461	**-0.1178646****
	P50	0.0071	**-0.1655723****
Total	Average	0.136326	**Non-recipients Avg.: 0.103**
	P50	0.172673	**P50: 0.147**

¥ Refers to clients with income below firm-level median income
+ Difference between branch-level and firm level mean income increase
** Difference between branch means and firm means significant at 95%

If differences in client impact between branches are not attributable to program or client characteristics, what explains them? The following quote by the credit and risk manager of FR summarizes the most common explanation given by managers for performance differences between branches:

> "The differences between branches are basically due to the managers and their teams. Branch managers must know how to handle their team of officers, who are not that easy to work with. They must maintain control of the branch, organize the work, transmit values and goals, support officers, motivate them, and worry about the clients. All these tasks are completely up to them. Sure, they have a set of tools and procedures we have developed to guide them, but at the end of the day they determine what happens at their branch, they are the bosses there. On the other hand, managers must understand the importance of loan officers and how central their role is in communicating the implications of having a loan to clients and fostering a payment culture. Just as branches are the bosses of their branch, the loan officers are the bosses of their clients' performance."

Loan Officer Practices and their Importance

Loan officers play a crucial role in the management and impact of loans. They are the sole point of contact between the MFI and the borrower. They authorize loans, they follow-up on borrowers and collect from them, they find new clients, and they bridge the information gap between the MFI and the borrower. In the words of the regional coordinator of FC:

> "Officers have four priorities. First, they are responsible for their zone, their portfolio and their clients as individuals. Second, each business in their zone must know that FC exists and must understand what it is we do, which means that they must constantly promote our services. Third, they must perform good credit analyses to make sure we don't over-lend to a client, they must understand that they are not selling a loan; they are selling a life-long line of credit. And fourth, when a person delays a payment, they must collect the loan. (...) This is why we call our officers advisors and not officers. They are the sole source of information about our clients; we need them to keep us informed to better understand what our borrowers are going through and how we should proceed with each of them."

Company policies provide very clear guidelines on the size of new loans according to client cash flows (for individual loans) or saving capacity (for group loans), potential loan increases according to repayment behaviors, collecting procedures according to number and frequency of missed payments, eligibility for new products, etc. However, they are no more than guidelines, and the level of discretion that officers have on interpreting,

implementing, and reporting on those guidelines is quite remarkable. The uncertainty under which they work, the overwhelming demand they face for their services, and their ever-scarce resources make it impossible for officers to truly follow every and all policies, they are thus necessarily given large amounts of discretion (Lipsky 1980). As one of the officers put it:

> "[The managers] here, they will tell you that officers work with the company's technology which gives you the terms under which you should lend and helps you decide whether or not to give out a loan and for what amount according to certain liquidity measures. Every officer knows it is him (sic) that gives out the loan. You can always manipulate the machines and policies. You go through the entire analysis process and at the end, if you trust the person and believe in her, you give her the loan. Maybe the liquidity index will not be enough according to the policies but if you believe in her, you will help her out [by changing the numbers] and you will take a risk together with her. The same applies in the other direction. A client may have a great liquidity index but if there is something that doesn't feel right to you, you simply don't give the loan, you tell them you will get back to them and you leave."

Many of the formal company policies that MFIs established were created following the "orthodox" views developed through the efforts of pioneer organizations like the Grameen Bank or BancoSol together with international investors and development agencies like the World Bank and ACCION International. On the one hand, MFIs depend on external donor and investor funds for their expansion. Given the amount of activity and literature that exists in the world of Microfinance, investors have come to expect a certain set of policies and procedures that show that a particular program "does things the right way." Additionally, employees often rotate from program to program and take certain lessons and practices with them. Finally, the environment in which these programs operate is, by nature, highly uncertain. They therefore constantly look for cues of successful programs both in their countries and in international literature to copy their policies and practices (DiMaggio and Powell 1983). At the same time, however, loan officers know that many of these practices can't possibly be followed as strictly as they are stated, given the uncertain and changing nature of their environment. There is therefore a light decoupling between them and the organization that works both-ways. On the one hand officers know that rules are only guidelines that can be bent and they are aware of their high levels of discretion. On the other, company managers know that

officers have much of the discretion, purposefully keep it that way and turn a blind eye to many of the rules that are broken or bent while externally (and internally) maintaining an image of strict rationality and rule abiding (Wilson 1968; Lipsky 1980). Even in the most analytical and numeric parts of the processes, where officers and branches report their results which are then translated into monthly performance measures, many of these processes are largely symbolic, to give a false account of rationality and meticulousness that is simply not attainable in the real life (Langley 1989).

A Typology of Loan Officers

Lending policies are not the only rules that loan officers (and their managers) routinely "bend" in the performance of their jobs. In fact it could be argued that all rules, except for the ones relating to corruption and dishonest behavior (which are strictly enforced), are not followed to the letter by many loan officers with the endorsement (and sometimes the active encouragement) of their managers. In the observation of loan officers and the ways in which they enacted firm rules and policies during their daily relationships with clients I found that, while policies –both strict rules and broad guidelines—define the ways in which a loan officer should relate to her clients, these rules and guidelines are systematically bent by certain officers while others tend to adhere strictly to them. To guide the rest of the chapter, I have inductively developed a typology of loan officers according to how they conduct their client relationships. Table 4 shows the different rules and guidelines that are destined to shape these relationships and the ways in which the two types of officers apply them. It is clearly not the case that officers can be perfectly defined by one of the two typologies, rather, each dimension can be thought of one of two extremes in a continuum and each officer is placed at a certain point within it.

"Spirit of the law" officers tend to have a flexible interpretation of company policies and rules. They see them more as tools that facilitate their job than as binding constraints. As a result, they tend to develop more personalized relationships with all their clients. They constantly ask them about their personal lives, they discuss the state of clients' business, they ask for referrals from them, and they often actively provide advice on business practices. In that sense, they become more embedded in their clients' environments. Like several accounts that discuss the role of government officials who are "embedded" in the

contexts in which they provide services (Evans 1995; 1996; Ostrom 1996; Lam 1997), these officers are embedded in their context, they have built personal connections with their clients, they speak their language, they empathize with them, they understand their condition, and they have therefore developed a personal stake in the personal welfare of their clients, not out of altruism but because they believe that such welfare directly impacts their performance as officers.

Table 4 – A typology of loan officers

Rule	"Spirit of the law"	"Letter of the law"
- Loan officers should maintain an institutional relationship with clients. Clients should see the LO as the institution, not as the person	- Relationships with clients at a personal level - Emphasizes personal character of relationship with client while constantly referring back to company as "the boss" or "company policies"	- Relationships with client at an institutional level - Emphasizes professional character of relationship, constantly highlighting the fact that he/she only represents the company and its investors
- LO should know the status of the client's business in terms of its profitability	- Close follow-up of business as well as personal activities, family issues, friendships, etc.	- Interaction mostly on a transactional basis, limits interaction to credit-related issues and business liquidity
- LO should know whether a client's referrals and guarantors exist and are trustworthy	- Knows a client's business and personal network and often refers clients to other clients, building wider networks	- Does not like to "get involved" with clients, prefers to maintain arms-length relationship and only checks on client's network to ensure potential pressure for repayment
- LO should not give business advice to clients due to liability issues	- Open to provide advice on business issues	- Afraid to provide advice on business issue with a "we could be liable" argument
- If a client is in trouble, negotiated agreements can be reached, but it is the LO's discretion	- Engages in joint problem-solving with client, especially in times of trouble	- No joint problem-solving, only interacts on contractual terms
- Loans must be collected upon and it is one of the most important measurement metrics	- Emphasizes trustworthiness of clients –"most clients want to pay"	- Emphasizes that clients can be devious –"most clients want to shirk"

In contrast, "Letter of the law" officers behave quite differently. I chose the term "Letter of the law" because these officers tend to be strong rule followers and usually do things strictly by the book. Given the uncertainty of their interactions with their clients, they refer to company policies and procedures when making decisions, thus reducing the uncertainty in their decisions and undermining their discretionary power. They choose to be bound by the rules, not because they don't think they could potentially bend them, but because these rules allow them to avoid making judgment calls that could have larger repercussions for them. They tend to assume that rules are there for a reason and were probably made by people who knew what they were doing, so they do not feel the need or the authority to question them.

On loan restructurings and other deviant behavior

The difference between the two types of loan officers can be seen in practically all their interactions with clients, but they are particularly salient and easy to document when a client misses payments on a loan. The three companies I studied have developed policies for loan renegotiations and restructurings for clients who are believed to be "morally solvent"[6] but who are suddenly unable to pay. It is always the discretion of the loan officer to offer such an option to her clients and it implies first offering it to the client or group and then taking the case to the branch manager for approval. When a client or group misses a payment, therefore, loan officers have the option of either collecting the loan following the contractual terms (through collateral in the case of individual loans or through the group in the case of group loans) or restructuring the loan through a negotiation process. The decision between these two options depends, most importantly, on the assumptions that officers have about the moral solvency of their clients and the reasons behind their delinquency:

> "True, when a client misses a payment it is nobody's fault but the client's; but as an officer you have to keep track of what your clients are doing, you have to stay on top of their needs. If you realize that your client is in a bad situation, you must give her a solution, you can restructure the loan, you can have a deferred payment [sic], you can

[6] The term "moral solvency" is used by MFIs to refer to a client's moral quality and payment ethic. There is obviously no direct measure of it and, while all employees use the term widely, they usually have a very hard time defining it with any degree of precision. In the absence of a credit record, moral standing is used instead. Another interesting aspect of the term is the fact that it is used by employees across companies. I am yet to find the origins of the term and how it spread across the companies.

> reapply the loans. You must constantly help your clients, you have to follow their needs. If you don't know what's going on with them and you don't try to find a solution for them you make bad clients out of good ones, you put them in a tight spot and both them and you will suffer from it[...]they won't be able to pay you and they will have to sell productive assets; or you will have to take over their assets to sell at 30 cents on the dollar and everybody loses. If you allow a person to get over-indebted, if you don't follow-up on your clients and help them when they need you, you will screw-up for sure."

An interesting observation arises here. Company policies around loan restructurings must exist at the company level for an officer to choose to offer them. However, it is still the loan officers' decision who to offer those mechanisms to and to what extent –in fact, restructurings only became an "official" option after they were practiced by several officers successfully (more on this later). Much of that decision depends on the assumptions that a loan officer has of her clients and their behavior. As one prototypical "Spirit of the law" officer, Mariana, commented:

> "Whenever my poorer clients approach me and tell me they can't make a payment because something bad happened to them, I have a policy of always trusting them. I offer them loan restructurings and deferred payments. Sure, some of my clients aren't morally solvent, but I can tell you that of every 10 clients I have helped, 9 have made it and 8 have become long-term clients. A restructuring is a great opportunity because you then develop a double commitment with your client. Some of my restructured clients have even become my friends. You get back what you give."

Contrast this with the following quote from a "Letter of the law" officer:

> "Clients are always trying to take advantage of you. They always tell you stories of reasons why they can't pay their loans, and they are usually good stories too. Truth of the matter is, people in this neighborhood are bad payers, and they have a non-payment culture; ask (competing company) and they will tell you the same thing. The last thing these people need is a loan restructuring, you have to be tough with them, you have to pressure them in any way you can until they pay you, even if it's out of exhaustion. Otherwise, they all learn that it is OK not to pay and they spread the rumor around to other clients."

From each officer's perspective, the described behavior is perfectly rational and oriented at achieving a better business performance. Both officers were working to achieve higher performance bonuses. They simply had different ways of thinking about the same issues. It would be hard to ascertain, *a priori*, which one of the two officers is a better performer.

Company policies and rules have developed following best practices and with MFI profitability, efficaciousness, and sustainability in mind. It would be logical to think that the people who follow these rules strictly would perform better, as they are good rules that exist for a reason. On the other hand, from the nature of the loan officers' work, we know that a certain degree of discretion is desirable if not necessary and in that sense, "Spirit of the law" officers may be better positioned to make the right decisions in uncertain situations.

Interestingly, "Spirit of the law" officers, who clearly make riskier decisions and systematically bend company policies that have been designed to ensure sound practices and profitability, are often among the top performers. Juan, FC's best performer according to bonus metrics[7] for several years in a row, is the prototypical "Spirit of the law" officer, and is very open in discussing his strategies. "Letter of the law" officers, for their part, can certainly perform at least at an average level, especially because the clients who are most affected by their behavior, as will be discussed below, are the ones that have the smallest loans, i.e. the poorest, that only comprise a certain percentage of an officer's client portfolio. That said, there is evidence that, on average, "Letter of the law" officers tend to perform worse than "Spirit of the law" officers. Carla, an officer who is the ideal-typical model for the "Letter of the law" officer, has one of the most aggressive collection styles, she is quick to contact a client's guarantors and put pressure on them so they will at the same time put social pressure on the client, she sends cases to the legal department for collection, and she will not hesitate to take a client's collateral for a loan. She has traditionally been an average performer in terms of new loans, but at the same time she has one of the highest delinquency rates, while operating in a zone neighboring Juan's (in fact there is a slight overlap between the zones). Her delinquency rates reached such levels that she is no longer allowed to give out new loans until she cuts them in half. However, it would be unfair and imprecise to say that "Letter of the law" officers are always poor performers. As I mentioned earlier, many of these officers are average –and sometimes above-average—performers.

[7] Loan officers are ranked according to their monthly bonus performance and this ranking is made known to the entire company. The particular structure of the incentive scheme is discussed later in the chapter.

Table 5 – Loan Officer performance by Type (FC)

Performance Metric (Observed Officers)	Observed Officers		All Officers		
	"Spirit of the law"	"Letter of the law"	"Spirit of the law"	"Letter of the law"	Unidentified
Average officers[1]	*73%*	*62%*	*66%*	***42%*** †	***44%*** §
Top percentile	98%[2]	93%[*2]	98%	99%	92%
Median percentile	*76%*[2]	*63%*[2]	*70%*	***44%*** †	***39%*** §
Bottom percentile	36%[2]	26%[2]	6%	3%	9%
STD of percentile	23.03%	23.13%	24%	31%	24%
Average Bonus Earned[3]	*140%*	*122%*	*123.5%*	***96.0%*** †	***100.8%*** §
Top Bonus	193%	173%	193%	198%	170%
Median Bonus	*139%*	*117%*	*124%*	***92%*** †	***91%*** §
Bottom Bonus	86%	83%	52%	39%	62%
STD of Bonus	41%	32%	35%	42%	29%
N	13[2]	9[2]	29[4]	23[4]	33[4]

[1] Measured from the average position in the monthly ranking according to bonus earned –main metric at FC—included months Jan-Jul 2004
[2] These only refer to those officers that I observed and I could code as either type. Some of the officers obviously don't quite fit in the two categories and were therefore left out of the analysis
[3] Bonuses are measured by the company as % of base salary received as bonus on top of the salary
[4] Only officers that had been in the company for the entire six month period were considered
* The top performer of Rule of Law officers was a borderline case, he was almost in the middle ground, but I chose to code him as Rule of Law to remain conservative
† Difference vs. Spirit of the Law significant at 0.05
§ Difference vs. Spirit of the Law significant at 0.01

Table 5 shows performance levels in terms of monthly rankings for the both the loan officers that I observed and could clearly code as one type or the other and for the entire population of loan officers at FC.[8] The trend shows not only that "Spirit of the Law" officers tend to outperform their "Letter of the Law" peers, but also that this difference in

[8] For this part of the analysis I asked two of the regional managers at FC who know the entire loan officer population to code each officer as either "Spirit of the Law," "Letter of the Law," or undefined. Both managers performed their coding independent of each other. As primer, I only showed them figure 4, and stressed that codes had nothing to do with performance but with operating style. I would read a name and they would place the name in a category. Two things were both surprising and revealing in this exercise. The first was how intuitive the typology seemed to them and how much they agreed with it. The second was the speed with which they could code each of the officers, taking them often less than a second to place an officer.

performance does not happen across the board. That is, on average, "Spirit of the Law" officers outperform their peers, but you would not be able to tell by only looking at their average performance. Where the difference in behavior between the two types of officers becomes salient, however, is in the effect that a loan has on the poorer clients. Understanding this difference, as I will show, can also help us understand the variation within MFIs.

The vulnerability of the poor

The role of particular loan officer and branch practices in impacting clients, especially the poorest ones, is highlighted when the mechanisms that explain why, in certain branches, poorer clients have a much harder time benefiting from loans. This phenomenon has been documented by other scholars as an "impact curve", where the impact of a loan is a non-linear function of initial endowments and the poorest clients experience smaller (or negative) net effects from a loan, whereas the "middle poor" experience the largest benefits (Hulme and Mosley 1996; Mosley and Hulme 1998; Morduch 2000; Pretes 2002).

MFI employees in the three companies covered by this study believe that negative (or flat) loan impacts are *always* –surprisingly, every single employee answered in the same direction— the MFI's fault; either because they lent too much to a client, or because they lent to a client they shouldn't have lent to, or because the client was not monitored properly throughout the loan. Understanding which one of these three mechanisms is more prevalent in determining negative loan impacts is important because each of them would have dramatically different implications. If it is mostly over-lending or inadequate client monitoring that lead to negative impacts, then the responsibility lies on the MFI's side, implying that it either led to over indebtedness by not applying conservative lending methodologies or that the negative impact could have been avoided by being more attentive to clients' needs. These conclusions would have a set of implications around improving client *handling,* better analyzing clients' payment capabilities, or establishing mechanisms to better monitor clients. On the other hand, saying that it was poor client *selection* that more commonly leads to negative impacts places more responsibility on the

client's side, i.e. while it was a selection error on the part of the officer, the client did poorly because there is something inherently "bad" about her, which would have implications concerning stricter filtering processes.

One clear illustration on whether it is a client selection vs. a client handling issue came from an interview with one of FR's top performers, Fer. Since one of the goals of my study was to understand how loans helped people better face their problems, I would often ask officers to refer me to credit applications they had rejected so I could interview the applicants and understand how they managed without a loan. Fernando has been an officer for several years and has been a top performer from the beginning, both in terms of delinquency rates and loan placements. When I asked this officer to refer me to a rejected applicant, he told me he had only rejected one applicant during his tenure as an officer, and it had been too long ago to track the client down. Fernando's case is not unique. I sat in more than 15 loan committees at several branches, where officers discussed new cases with their managers to determine whether to approve the loans and for what amount. Hundreds of cases were brought in to these meetings and I did not witness a single rejection. On the other hand, the fact that the three companies I researched are so concerned with avoiding over lending and have developed policies to determine client liquidity levels to ensure conservative amounts would suggest that over lending is not pervasive enough to systematically drive the performance differentials. The lending methodology these MFIs follow is actually structured around *under* lending; only increasing loan amounts as clients prove they can pay, which is consistent with common practice (Jain and Moore 2003; Armendariz de Aghion and Morduch 2004).[9] More importantly, given that lending policies are defined equally for all branches, over lending would not explain why some branches systematically show lower performance.

Client interviews –especially with clients that dropped-out—showed overwhelming evidence that the key factor that affects borrowers is their vulnerability to external

[9] While it could be argued that increasing amounts based on successful loan repayments will eventually reach the breaking point for each client, it would not explain the impact curve itself, it would rather be an explanation for loan defaults in general. It would also predict that all clients eventually end in default, which does not show in the data.

shocks. [10] Poorer households have a heightened vulnerability to contingencies given their lack of assets and/or savings to absorb negative shocks, as well as their reduced social network structure (Morduch 1994; Alderman 1996; Coulombe and McKay 1996; Gertler and Gruber 1997; Czukas et al. 1998; Morduch 1999; Zaman 2001). When a contingency –even a small one—occurs, they are often sent on a downward spiral that crumbles the economic progress they had achieved thus far. Several scholars recognize the existence of this vulnerability problem and even stress the importance of MFIs in reducing its negative effects (Hulme and Mosley 1996; Khandker 1998b; Zaman 2001; Sala-i-Martin 2002; Khandker 2003), but there seems to be no clarity of under what circumstances microloans help mitigate vulnerability and when they only increase vulnerability by indebting borrowers more.

Consequently, an overwhelming majority of the clients who started performing poorly with their loans began doing so after a negative external shock, be it a child's or personal illness, the death of a relative or the theft of some of their productive assets. Surely, contingencies happen to people in all levels of poverty, but the more destitute have much less to hang on to, both in terms of assets and in terms of social capital. If we think of contingencies and negative external shocks as following a stochastic process, where all people have an equal probability of receiving a shock, [11] but the poorest have much less

[10] The literature has proposed several other mechanisms that could drive this impact curve. The first is that poorer households probably use loans for subsistence or other types of consumption rather than invest them in productive, income-increasing activities. Evidence from client interviews, however, questions the assertion. First, all types of clients and all levels of poverty engage in this behavior. Second, poorer clients are much more likely to invest the totality of their loans in productive activities given that their loans are much smaller and leave them with little room to maneuver. An alternative explanation is that the impact curve reflects the willingness to take risks, where lower-income clients are more risk-averse and therefore make less productive investments (Mosley and Hulme 1998; Pretes 2002). It is undoubtedly true –and indeed almost tautological—that poorer people make less productive investments. It is a different story to say that poorer people *choose* to make less productive investments. I constantly probed for this type of decision in my client interviews by asking them about the ideas they thought about for investing the loan resources and what other activities they would like to invest in if they had larger loans. I found that people did not invest in more productive activities because they did not have access to the investment opportunities and ideas and, in the rare cases when they did, these ideas often required higher investment levels than the borrowers' economic capability. It is certainly true that poorer people sometimes have a higher sense of risk, but this is not because they are risk averse, it is because their *relative* risk is much higher than better endowed people. It is also true, however, that they see risk taking as a normal, everyday part of their life (Morduch 1994; Besley 1995; Jalan and Ravallion 1997; Czukas et al. 1998; Morduch 1999).

[11] It would be easy to assume and indeed has been demonstrated that poorer people actually have a higher probability of receiving an external shock.

tools and ways to deal with that contingency; then the impact that such a shock would have on them is considerably larger –especially in relative terms—than the one that less destitute people would face and such an explanation would indeed show up in an impact curve. More importantly though, in cases where there was an external contingency for one of the more destitute clients, and the loan officer took the time to understand the clients' situation and support her through loan restructurings and other means such as deferred payments and contingency loans, vulnerability was indeed mitigated. That is, "Spirit of the law" loan officers that, through their understanding of a client's situation and constraints, decided to use their discretion to grant clients a second chance were able to mitigate or counteract potential negative impacts. In cases, however, where a contingency was matched with an unresponsive officer who tried to collect on the loan in a business-as-usual manner, the loans only pushed clients further down the spiral.

This means that the level of discretion and interpretation on the part of certain loan officers is very important, especially for poorer clients. Putting pressure on a client in times of trouble and not helping her find an exit often only leaves the option of informal moneylenders who can have, and indeed almost always do, disastrous consequences.[12] Looking at all FC restructurings, I found that every application was eventually approved (some after subsequent negotiations), 80% of those restructurings were paid in full and on-time, and 51% of those clients stayed as clients afterwards. This is compared to a 40% rate of collection on defaulted loans that are not restructured –and obviously a 0% of client renewals from that group (see table. 6).

While this behavior may seem unduly altruistic, it is not necessarily the case. As I mentioned earlier, the officers that emphasized and practiced client support are more often than not among the best performers. This is not due to an incentive distortion,

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[12] These interactions usually send people on "debt spirals." Individuals start taking out loans for diverse sources to pay out other debts. Given that they are not making any productive investments and that the loans they have to take out are increasingly risky and therefore have increasingly high interest rates, they become entangled in a debt trap. As a telling example, I met two women who started with loans of $50 and, after debt spirals, one owed $50,000 and the other owed $25,000. Considering that the MFI's assessment determined they could only afford to pay out a $50 loan, the size of these debts should achieve its relative proportion in the reader's mind.

where officers are being rewarded for activities that go against the company's interests. The incentive schemes followed by the three companies closely mimic the best practices discussed in different research circles, where a large portion of officer compensation (over 50%) is calculated on a variable basis, determined by a combination of goals like the number of new loans signed, total amount lent through new loans, percentage of loan renewals, and delinquency rates. Delinquency is usually one of the most salient parts of the bonus and is often the first thing that managers look at to gauge officer performance.

Table 6 – Restructuring vs. Standard Collection

	Restructuring	Collection+
Approved	100%	-
Repaid	89.9%	43.2%
Stayed as Client	45.6%*	-

+ Only loans that were sent to the legal collection department are considered here. Once a loan has accumulated three or more delayed payments there are two options available to the officer: restructure or go to the collecting department. Here we are considering the results between the two options.
* As a percentage of total restructurings. The percentage of people who stayed as clients given they restructured and repaid is 51.2%

Loan officers, particularly of the "Spirit of the law" kind, are instrumental in mitigating poorer borrower vulnerability and enhancing loan performance in an additional way that also implies bending formal rules. Poorer households tend to have smaller and more isolated social networks and don't access them as often to look for business ideas or to discuss their problems (Besley 1995; Lund and Fafchamps 1997; Morduch 1999). More affluent, dynamic clients seem to have access to larger, more diversified networks that help them find better investment opportunities and they use those networks more often and more effectively. Poorer borrowers often don't invest in more productive activities simply because they don't know about them. More affluent households have better social networks that, in turn, give them access to better investment ideas and opportunities. To test for the hypothesis that poorer households have weaker social networks, I used another piece of information from FC's database. As part of the loan application process, prospective clients must give the names and contact information for at least three references. Officers then must check on the references to verify if they are valid and

whether they speak positively of the referee and each reference is scored in those terms.[13] I created a score of personal references using those data and ran a simple regression of the value of the *initial* reference score against the *initial* household income of the clients. The result, shown in Model I of Table 7 shows a positive and very significant coefficient, even after controlling for other individual, observed factors. Placing that score in a fixed effects model for household income increase after receiving a loan –Model II—also yields a positive and significant coefficient, which would mean that individuals with better referrals tend to increase their incomes more rapidly.[14] In addition, the interaction between receiving a loan and references shows in Model III that the effect of having better references is potentiated by receiving a loan (or better references dramatically increase the impact that a loan may have). Moreover, Model IV shows that the effect of having better references is strongly affected by initial household income, where higher initial endowments allow for better use of references as can be seen in the interaction between initial income and references.

In similar fashion, officers can play an important role in bridging networks among clients in the case of individual loans or in activating the latent but existing social networks of group loans;[15] in the words of a manager:

> "Officers, more than anything, are information brokers. They have information on each of their clients and sometimes on people that each of their clients knows. They use that information to determine the moral and economic solvency of their new prospects, to detect when a client is in trouble, to be more effective when they need to collect. They can also use that information for their clients' benefit. They have seen hundreds of similar businesses and situations; they have seen what works and what doesn't. They know many people in their communities; they know who does what and who knows who.

[13] The scores are as follows: a reference that proves to be non-existent is given a 0. An existent but neutral reference (nothing good or bad to say about referee) is given a 1. An existent and positive reference is given a 2. An existent but negative reference is given a -1.

[14] Note that these are all fixed effects models, so they are controlling for individual heterogeneity that could account for the fact that certain individuals both have better connections *and* increase their incomes more. In addition, note that they are two-stage models which also account for the selection effects that may occur in receiving a loan.

[15] What I am referring to here is the fact that communal banks meet, by obligation, every week. In most cases, these meetings are limited to the collection of payments and running the group's numbers. In some instances, however, I saw how an active engagement of all the members by some loan officers made them participate in joint problem-solving for other members and in an active exchange of business tips and ideas.

When officers use that information to benefit their clients by connecting them with people and giving them advice, they can truly help them."

Table 7 –Personal References, Income, and Loan Impacts

Model	**Model I**	**Model II**	**Model III**	**Model IV**
Dependent Variable	***References***	***Increase in HH Income***	***Increase in HH Income***	***Increase in HH Income***
Credit	-	3.862 (4.46)	3.178 (4.48)	10.77*** (4.10)
Initial HH Income	0.000129** (0.000061)	-	-	-0.000263*** (0.000032)
References	-	0.0107* (0.0061)	-0.287* (0.16)	-0.0393** (0.018)
References * Loan	-	-	0.281* (0.16)	0.096544 (0.1654)
References * Income	-	-	-	0.0000161*** (0.000005)
Intercept	4.439*** (1.10)	-3.711 (4.41)	-2.934 (4.43)	-9.818** (4.07)
Total Client Groups	--	*1282*	*1282*	*1282*
Fixed Effects	*No*	*Yes*	*Yes*	*Yes*
Selection Effects[¥]	*No*	*Yes*	*Yes*	*Yes*

*** $p < 0.01$ ** $p < 0.05$ * $p < 0.1$

Note: Total of 1,735 clients in the model with an average of 2.6 observations per client.
Standard errors in brackets
¥ First stage in model included references, income, gender, home quality (6 measures), education, debts, assets, dependents.

In that sense, officers that can create bridges between lower income clients and their communities can offset their lower access to social networks that carry business opportunities, best practices, and risk mitigation.

Discussion

Loan officers, loan impacts, and path dependence

How can we explain this paradox of apparently lenient officers, who decide not to aggressively collect from clients when they miss a payment, also being better performers in delinquency rates and other measures? Why do apparently lenient, "Spirit of the law" officers perform better than "Letter of the law" officers? And, given that "Spirit of the law" officers seem to perform consistently better than their peers, why do we continue to see both types in relatively equal numbers?

The first thing that must be clarified is that the "Spirit of the law" officers do not behave in this understanding, lenient way with all their clients. As I mentioned before, officers base their restructuring decision on a set of assumptions of the moral solvency of their clients and the reasons behind their delinquency. More concretely, the situation in which I most often saw "Spirit of the law" officers engage in loan restructurings with delinquent clients was when these clients were relatively poorer. In fact, when relatively wealthier (middle poor) clients missed payments; "Spirit of the law" officers were often as strict and unyielding in their collection practices as "Letter of the law" officers. The second caveat is that officers are not really being lenient, even with poorer clients. In the credit framework, missing a payment or defaulting on a loan is interpreted as a signal of moral standing. If I lend you money and you miss a payment, then I know you are not to be trusted and I will try to collect the remainder of the loan from you as soon as possible, as well as close the option of future loans. For poorer people, however, the non-payment signal is much noisier because the non-payment is likely to be derived from a contingency that left them no choice; they have no other means of securing a payment. Moreover, an aggressive collection strategy may go against the company's interests, because by weakening the clients' already floundering economy the prospect of future payments may be further jeopardized.

Loan officers who seem lenient from this perspective may simply be better signal readers, or people who acknowledge the fact that the signal is so noisy that it can't be taken at face value. A blurred but nonetheless present boundary exists between the clients,

especially the poorer ones, and the MFIs. It is a class boundary but it is also a cultural and language boundary that renders much information coming from the clients undecipherable and indeed in many cases unrecognized to the MFI. Certain loan officers act as bridges between two different worlds, translating a language and therefore crossing the boundary that renders some of the poorer clients' behavior unintelligible for most managers and employees of the MFI.

Another part of the answer lies within the previous quote from the "Spirit of the law" officer, Mariana. Her most loyal and long-term clients are the ones she once helped. Helping a client in a time of need generates a double commitment, just as an aggressive collection strategy may, as I quoted Juan saying above, "make bad clients out of good ones:"

> "This officer is treating me as if I were a criminal, as if I were missing payments by choice. I have missed some payments because I really have no money right now. (The officer) figures that by trying to scare me with legal threats I will pay my loan. I know that legally they can't do anything to me.[16] I will pay my loan because I feel committed and it's the right thing to do, but tell me something: here is my neighbor who lent me money now that I was in trouble and here is (the officer) who has threatened me and insulted me. I am going to pay my debts to both of them eventually, as things improve, but which do you think I will repay first?" (Client 1)

It is worth noting that clients who missed payments entirely because of an external contingency and received a loan restructuring *still* have the repayment incentive that comes from the prospect of a continuing line of credit with potentially increasing amounts. This is a very important point, because most of the literature on MFI best practices constantly emphasizes the importance of strict collection practices to "educate" clients and send the signal that non-payment will not be forgiven. The advice is not misplaced. It comes from the early days of microcredit programs –especially government-sponsored ones—that through very lenient collection practices distorted the clients' incentives to repay and quickly found themselves with unsustainable delinquency

[16] The Mexican legislation does not allow for collateral confiscation in case of missed payments, but (aggressive) loan officers often use that together with other "hollow" legal threats to try to collect delinquent loans. This quote is particularly interesting because officers base their threats on the assumption that clients don't know the law and therefore feel truly threatened. I was myself surprised to find how knowledgeable most clients are of their legal rights and the extent to which legal threats are not really enforceable.

rates (Hulme and Mosley 1996). The paradox then lies in understanding why these clients who missed payments and were helped by their officers don't learn from this non-payment experience that future non-payments will again lead to restructurings, thus losing their incentive to repay. There are two complementary features of the restructurings that explain it. First, they are not an *automatic* response to a non-payment. While it is true that the policies and mechanisms for the option of a restructuring to exist lie at the company level, the decision to actually restructure a loan lies in the officer. Officers carefully stress this fact in the language they use with the clients when making these decisions by accentuating their personal agency and stake in the decision with expressions such as "I am going to help you out on this", "I will take this risk with you," "I might get in trouble with my boss, but I'm willing to work this out with you," and so on. By personalizing the restructuring decision, the officers highlight the fact that they are going against "standard" collecting practices and are making an exception for the client, and the clients understand and appreciate it as such:

> "I am very thankful to (officer). My [solidary] group started missing payments because one of us had some problems, as her children got really sick. I told (officer) about the problems we were having as a group and he knew we were trying hard to keep the payments coming, but things weren't good and we ended up missing several payments on our loan. I was expecting the lawyers to knock on my door any day, the loan term had ended and we still owed some money. Then one day (officer) visited me and offered me to restructure my loan. It was such a surprise! We put in an additional effort and managed to pay what we owed. Of course, even though I greatly needed it, I didn't dare ask for a loan renewal, but (officer) again visited and asked me why I wasn't renewing and encouraged me to do so. I have never missed a payment again." (Client 2)

Second, and related, given that the restructurings are viewed as an exceptional opportunity, they are also understood to be one-shot deals. In the restructurings I witnessed, as the officers negotiated the terms with the clients, a common expression was "you know that I am making this exception for you right? If you fail me on this, you are going to get us both in trouble, because then I really won't be able to help you and I will have to send your case to the lawyers." Double restructurings are not practiced. Clients know that a restructured loan is their last resort and they appreciate it as such. Sure enough, some clients don't manage to solve their problems even with the restructured

loans (remember that 10% of the restructurings aren't repaid), but even in those cases where collection has to be made forcefully, that collection is viewed in a different light:

> "Once I had a client who asked for a restructuring because he had had some health problems. We went ahead with it and still, he wasn't able to recover and he couldn't pay the loans. He was very committed to paying; he just didn't have the money. His neighbor walked by as we were talking once. When he found out about this situation and how we had helped the client out, he volunteered to pay the loan himself, as he thought it wasn't fair for us to lose money once we had helped his neighbor."

Or, from the client's perspective:

> "I am thankful to (the officer) for understanding my situation. She really took the time to talk to us and learn why we had missed our payments. She restructured our loans and helped us manage the tension with the branch manager. We are still in trouble though, and we are not going to make the payments. We still go to the branch every week to let them know that we are very committed to them and that we will certainly pay them back. We offered some of our things as payment but (the officer) didn't take them. Every time I get some extra money from my debtors, I take it straight to the branch. They know I will pay them, I feel very indebted to them." (Client 3)

Third, and extractable from the previous two, the fact that the restructuring is viewed as an exception made personally by the loan officer generates an additional level of commitment on the part of the client due to basic norms of reciprocity. Following Gouldner's description of reciprocity norms, he stresses that the size of the repayment obligation is contingent upon the *value* of the benefit received, which is in proportion to and varies with the intensity of the recipient's need at the time the benefit was bestowed, the resources of the donor, the motives imputed to the donor, and the nature of the constraints which are perceived to exist or to be absent (Gouldner 1960). In this case, we can see why the restructuring is of such high value to clients. They were in a moment of great need, the donor is perceived to be giving the benefit for personal reasons under strong institutional constraints ("I will get in trouble with my boss but…").

It can be argued that the only reason why clients go to extra lengths to repay their loans once a loan officer has helped them with a restructuring has nothing to do with reciprocity. It could be that, for them, the "shadow of the future" looms very large and they see the economic benefit of maintaining their source of credit. This is undoubtedly

true for all microcredit clients. Usually the programs are structured around such incentives, offering clients increasing credit amounts as they successfully repay loans, or "dynamic incentives" (Jain and Moore 2003; Morduch and Armendariz de Aghion 2005). The only difference between clients 1 and 2 quoted above would then be that the second has an option to continue accessing a line of credit while the first doesn't. While economic incentives are certainly a central part of the story, there is evidence that it is not the only part.

Fig. 1– Monthly Growth in Delinquency Rate –Branch 32

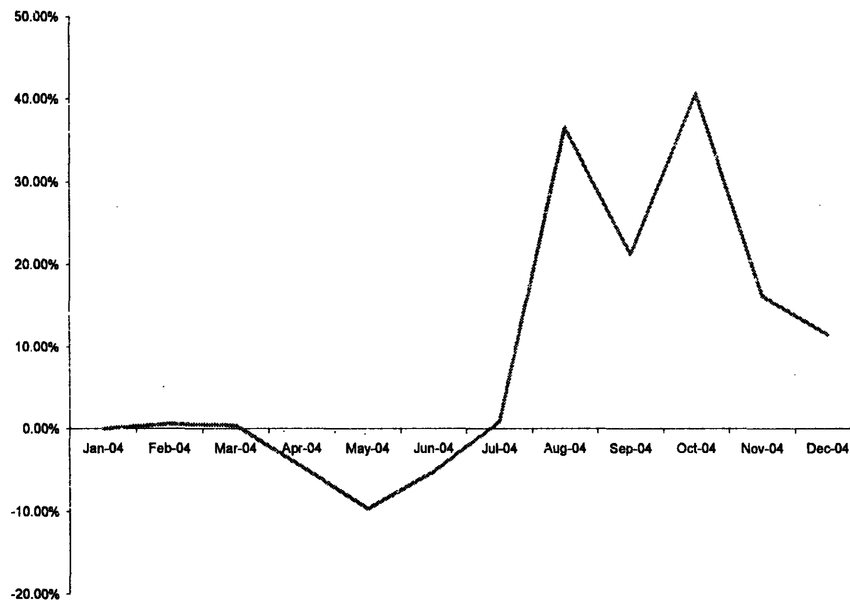


Figure 1 shows monthly rates of growth in delinquent loans for one of the branches I observed. Typically, growth rates around delinquency are relatively stable –especially for well-performing branches—and oscillate around 0. However, it is not uncommon to see spikes such as the one that occurred in branch 32 in the month of August. As it can be seen, usually the rates normalize again after a few months. After analyzing several such spikes in different branches I enquired regional and general managers of the three companies I worked in to understand why they should happen. External shocks to the local economy are obviously behind some of those spikes, but the story is more complex, as one regional manager of FR explained:

> "You know? Those spikes used to drive me completely insane. I just couldn't understand why a branch that had been a consistently solid performer should suddenly see a delinquency increase like that. At first I thought it had to be something about the local economy (...). I realized something: the spikes happened whenever we relocated a loan officer to a different branch. Sure enough, I started asking clients why they had decided to stop paying for their loans and they would answer straight up that they missed their past officer and they didn't like the new one!"

This finding was corroborated by managers in the three companies. Whenever a loan officer –and they usually stress that it especially happens for "good" loan officers—is relocated, delinquency rates among her previous clients increase significantly. Moreover, in the words of one of FC's general managers:

> "Those delinquency spikes are especially high when we move a good loan officer out and a different one comes in. We also found that a way to mitigate the spike from happening is if we get the previous loan officer to introduce the new one to a good amount of his clients before leaving. Whenever we do that, it seems like the clients shift their personal commitment from one officer to the next."

If clients only care about the shadow of the future of their credit line, why should that shadow disappear when a loan officer relocates? At least a subset of clients sees a personal commitment to the loan officer above and beyond the shadow of the future of their loan. Several factors seem to enhance the value of the loan officer-client relationship beyond the pure value of current and future loans. First, there is the business advice and contacts that "Spirit of the Law" officers provide to their clients. Second, the reciprocity tie that is built through the relationship between the officer and the client is personalized and the client feels committed to the officer above the company. Once the loan officer leaves the additional commitment created by the relationship is lost and the client feels like the tie is broken. If a new officer that the client doesn't "like" comes to replace the one that actually approved her loan, she does not feel as obligated to maintain the relationship anymore because of the broken tie.[17]

[17] Loan officers often remind clients that it is the company and not the individual that grants the loan, but the clients still perceive (and to some extent they are right) that it is the individual officer that gave them the loan.

Given the importance of these ties, the fact that a client was not trusted or helped with a restructuring even though she was morally solvent may create a self-fulfilling prophecy in which the client feels disempowered and disrespected by the officer and therefore engages in punitive behaviors or loses interest (Peel 1998; Tyler 1998). That is, the different types of officer behavior arise and can be sustained because they are the product of different mental models, logics of action, or starting points that loan officers have in their interactions with clients. The two clients cited above were actually quite similar. They were both seamstresses, they had both gotten in trouble because of an external shock to their earnings, they both had similar levels of earnings and loan sizes, and they had both been good clients up to that point. In the second case, the fact that she (and her group) received help from the loan officer developed in her a sense of commitment and need to reciprocate which then pushed her to exert extra efforts to repay her loans and stay on as a client. In the first case, the client felt disrespected and disempowered, she felt unfairly distrusted and as a result felt no need to prioritize payments to her officer. This means that the behavior that was prompted by the loan officers' assumptions about their clients actually confirmed those assumptions, thus reinforcing their overall approach to clients. Loan officers can therefore embark on different paths depending on their initial assumptions and will continue to update their heuristic based on the outcomes of their actions (Hardin 1993). In Hardin's view, however, whether an agent's counterpart reciprocates trust or not is an exogenously defined variable, whereas here I am suggesting that it is –at least partially—a function of the agent's behavior towards her counterpart. This implies that, as I observed in the two stable types of loan officers, there are two relatively stable equilibria that can develop and that are self-sustaining. This is reinforced by the fact that, as I mentioned above, restructurings must remain as discretionary options and cannot be institutionalized as a standard response given the incentive distortion it would create for clients. Standard rules, therefore, still support "letter of the law" behavior.

Loan officers and branch performance

How does this all translate to the branch level? Officers, after all, operate on a client-by-client basis, and whether a single officer performs better or not is not necessarily linked to branch operations. At the same time, the effect of individuals and branch managers in

performance differentials between bank branches has been documented before (Ichino and Maggi 2000). There are several ways in which officer and branch performance are linked. First of all, officers interact very intensely within each branch and can therefore greatly impact the culture inside it, both through their daily interactions and through (formal and informal) new officer training (Van Maanen and Schein 1979).

Second, officers report to branch managers. Loan restructurings and deferred payments must be cleared by branch managers once officers propose them. That is, loan officers choose to restructure a loan or offer deferred payments and they take them to their branch manager who must then approve them. At the same time, managers can encourage officers to seek creative solutions when their clients are in trouble. In that sense, having a "Spirit of the law" branch manager can facilitate such behavior for officers who naturally pursue it and can encourage it on those who don't. Branch managers are usually promoted from within the officer ranks. This means that a "Spirit of the law" officer will tend to be a "Spirit of the law" manager and so on. Managers on better performing branches had an amazing grasp of who their clients were, what situations the problematic borrowers were going through, the status of delinquent loans and the relationships between the different clients.[18] I do not mean to say that "Spirit of the law" managers did not put pressure on their officers to reduce delinquency rates. In fact, they were often much more strict on pushing officers to check upon their clients as soon as they missed their first payment. The type of collection they promote, however, is of a joint problem-solving kind. They like to solve their problems locally. Better performing branches very rarely send matters up to the legal department. They have learned that it is much easier to collect from delinquent borrowers "the easy way," in a personal manner, and through joint problem-solving. One manager spoke about sending collection to the legal department as "kissing that collection, your client, and your client's friends who are also clients goodbye".

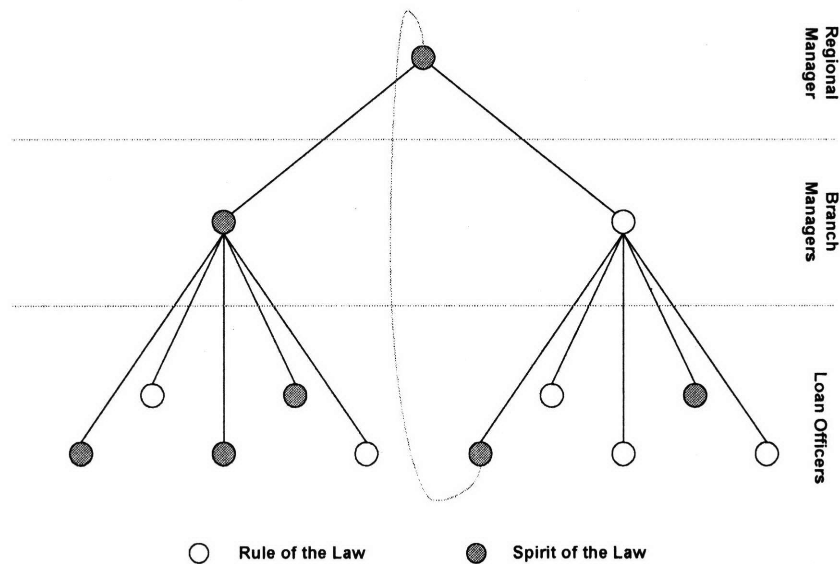
[18] I was often surprised to see managers in the best performing branches often know a loan officer's clients better than the loan officer herself. It is not a rare sight to see these managers remind an officer that "Martha is your client who is the cousin of the butcher and she is friends with the seamstress that is also a client here, remember her now?"

In that sense, the presence of "Spirit of the law" officers and especially managers can make certain branches look like "Spirit of the law" branches, and the opposite is also true. However, the influence that different types of managers can have on their officers is not equally strong. That is, when same-type officers and managers interact, there is a full understanding between them on how to handle client situations. When different types interact, however, the differing mental models become salient. In loan defaults, for example, I observed several interactions between managers and officers of different types. When a "Letter of the law" officer tried to collect aggressively from a client who could not pay, she only had the legal recourse left. Accordingly, she would ask her manager to send the collection up to the legal department. If the manager was of the "Spirit of the law" type, he would ask who the client was and who the client's references were, and would ask to set up an appointment with the client before taking matters further up. During that appointment, the manager would try to find a negotiated solution in the manner described above. In so doing, the "Spirit of the law" manager generates that type of behavior within her branch, because of the close supervision over officers and the close interaction with clients. The opposite, however, is not usually true. I also observed interactions between a "Spirit of the law" officer and a "Letter of the law" manager over what to do with a delinquent client. The officer pushed for a restructuring giving a detailed description of the reasons why the client had missed the payments, the client's history and references. I observed two cases where, when the manager pushed back and suggested to send the loan to the legal department for collection, the loan officer adamantly refused, eventually seeking the regional manager directly to work on a restructuring (See fig. 2). For these "Spirit of the law" officers, it was not acceptable to seek legal pressure on their clients as they saw it as a deeply unfair solution that would only make matters worse. Having learned that their clients were strong reciprocators, these loan officers were simply not willing to break that trust by engaging in unfair behavior (Fehr et al. 2002; Fehr et al. 2004).

Third, officers enhance organizational learning through their previous experiences and personal acquaintances. In her work on organizational learning, Linda Argote has emphasized how previous personal acquaintances, previous experiences, and prevailing

characteristics of individual employees can enhance learning and organizational performance, especially in service organizations (Darr et al. 1995). She has also shown that in conditions of increased input uncertainty, such as the environment in which loan officers operate, increased employee discretion, flexibility, and on-the-spot decision making increases organizational learning and group effectiveness (Argote 1982). This means that a branch that has "Spirit of the law" officers and manager is likely to be a more effective learner than one that does not, which would generate a virtuous performance cycle.

Fig. 2– Interactions between types at different MFI levels



Fourth, loan officers who can bridge the boundaries and contact clients are better at understanding their needs and then selling them to their managers. In the right cases and environments, officers are bound to shape and modify branch-level practices through selective issue-selling activities (Dutton et al. 1997). Good loan officers can have a greater influence on good managers who, in turn, can sell some of their learning to upper management, thus improving company-wide policies. This is a central point, as it helps us understand how loan officer practices can shape MFI policies. Indeed, the policies for allowing for restructurings and deferred payments, for example, had not been contemplated from the beginning. Formal rules only established a collection procedure that included confiscating assets and legal actions –what typical "Letter of the law"

officers follow. Restructurings only became an official option *after* they became a relatively widespread practice among loan officers. That is, certain loan officers, increasingly frustrated with the lack of options for handling client defaults, disagreed with official collection practices, as they knew it only made matters worse for good clients. Using their discretion, certain loan officers began exploring other options –with full knowledge of their branch managers. FC's central credit manager recounted how restructurings became officially sanctioned:

> "It all started with one officer (Juan, the same as above) who requested an appointment with me, which seldom happens. In the meeting, he complained bitterly about our collection practices, which I knew were less than perfect from my days as an officer. He recounted how he had refused to collect from a couple of his clients and performed an informal restructuring. His branch manager supported him at first, because he was such a high performer, but as the number of restructurings increased, she became increasingly nervous and demanded that he seek approval from me. We went over the numbers, and his clients were actually doing very well, so I authorized his actions. After that, the branch manager, Juan and I had several meetings to discuss how to design a restructuring policy, which I refined by talking to other officers who were also engaging in unofficial collection practices."

Note how the inadequacy of some rules led certain loan officers to bend them –or in some cases break them—to find better solutions, which were later formalized as they showed superior results and became widespread practices. A similar process can be observed with other rules. For example, there is a formal policy against giving clients specific business advice. MFIs discourage this kind of activity as it has clear potential liability issues should a client follow an officer's advice and fail. Certain officers, however, routinely break this rule and they spread their knowledge of best practices to all their clients. Given the impact that such knowledge often has, two of the three MFIs studied are in the process of formalizing this process through the creation of client fairs, formal training sessions, and formal networking sessions run by the best performing officers. By experimenting with new practices through routinely breaking existing norms, certain loan officers find innovative and sometimes better ways of achieving company goals. Ironically, it is by constantly bending certain norms and pushing them at their margins that company policies can be improved. This is even within a context where years of

experience and research have converged on a relatively narrow set of institutionalized "best practices" which are preached across the world.

Conclusions and Future Research

I am not trying to imply that loan officer practices are the only key to MFI performance. The companies I analyzed have spent many years devising a set of policies and operational systems that have allowed them to standardize operations and reduce costs. They have created sophisticated –and successful—incentive schemes to monitor and regulate their employees, particularly loan officers. They have refined their service offering, making the loans increasingly attractive and accessible to their clients. They have devised strict practices to make sure that loans match the clients' payment capabilities. They have established effective collection practices and have reduced delinquency rates to impressively low levels. The main point I am trying to make is that loan officers –largely neglected in the literature—matter, and they matter a great deal. By understanding, acknowledging and addressing the poorer borrowers' problem of vulnerability, certain loan officers and branch managers have managed to reduce their delinquency rates, increase their loan renewal rates, and avoid negative impacts for their more destitute clients. These officers do not ignore company policies. Rather, they use them as useful guidelines and tools that facilitate their daily work. This means that MFIs and researchers alike should pay much more attention to particular managerial and loan officer practices to deepen their understanding of the determinants of performance and to devise better policies and regulations. The fact that formal policies are not always applied to the letter, and in fact are routinely bent by better performers, questions the validity of a sole focus on contractual or organizational structures as the appropriate level of analysis.

I am also not trying to imply that more discretion is necessarily better and we should do away with rules, policies, and structures. Company policies are an indispensable requirement to guide and motivate employee behavior. I am rather making the point that discretion is inevitable, especially in certain contexts, regardless of the quality and complexity of formal policies. Managers need to be aware of that fact in order to steer discretion –which is unavoidable—in a positive and fruitful direction. For example, rigid policies that don't allow for client contingencies, don't provide mechanisms for the

supervision and involvement of officers in intra-group lending that is often resorted to in case of member need,[19] and excessively severe collection policies often only worsen a client's situation and the company's prospects of recovering a loan. The mechanisms must exist for deferred payments, loan restructurings, contingency loans, and other contingency-handling mechanisms that follow-up on borrower needs and their current situation. However, the reason why those mechanisms worked in the cases I analyzed, was because they weren't a standard response and they were left to the discretion of the loan officers under the supervision of their managers. Loan officer discretion –especially of the "right" kind—should therefore be understood, embraced, and encouraged.

The role that "Spirit of the law" officers have had in shaping and improving MFI rules and procedures should be noted as well. These officers have a flexible interpretation of company rules and, by entrepreneurially bending and applying them, they have achieved more efficient outcomes than what the structure would allow for. Moreover, through their outstanding performance and "issue selling" within their branches and the larger organization, they have been able to institutionalize their rule deviance into improved policies (Argote 1982; Darr et al. 1995). This could provide an insight into how formal rules and institutions can be modified and improved not through increased compliance and enforcement, but through certain types of deviance.

Where do "Spirit of the law" officers come from?

If the role of loan officers is so crucial, especially in the case of poorer clients, then it is important to understand what determines whether a loan officer is a "Spirit of the law" officer or not. A simple skills or intelligence answer will not suffice. Officers follow a very strict, standardized recruitment process where they are subject to several tests, exams and interviews. They all have similar academic backgrounds and the process is exactly the same, performed by the same people, for all officers. In the cases I analyzed, however, I often found that officers who were once microentrepreneurs or whose parents or siblings are or were microentrepreneurs were more prone to act as "Spirit of the law";

[19] In most communal bank programs, the groups are allowed to lend money from their internal savings fund to one of the members if they so choose. When this process is not supervised, however, it can easily lead to over-indebtedness and instead of an additional cushion it can become an additional threat.

taking much more time to enquire about client contingencies, showing more trusting behaviors both when granting loans and when borrowers missed payments, and showing much more proactivity to find creative solutions with their branch managers for particular clients. In this sense, the background of officers might strongly shape their views and concerns about fairness and reciprocity. Given that these loan officers either come from the same background as the clients or they have interacted with them much more intensely, they have developed a sense of Bounded Solidarity with clients, as they believe that they share, to some extent, a common fate (Portes 1998). Also, because of their background, they may have had more opportunities to interact with the same type of people as their clients and "update" their calculation of how much they can trust them (Hardin 1993). Given their background and experience, certain officers are therefore better signal readers and have a wider set of cultural tools to understand their clients and bridge previously disconnected communities of meaning (Skocpol 1985; Zerubavel 1991; Piore 1995). Finally, there is likely to be a relationship between the training that an officer received –especially informal training—and the type of behavior she shows. The process through which officers are socialized into the organization and their particular branches is bound to have a lasting impact on their personal style and understanding of their clients (Van Maanen and Schein 1979). This is especially true given the self-reinforcing nature of the paths that loan officer-client interactions can take, where initial interactions can become self-fulfilling prophecies of future client behavior (Peel 1998). Future research would seek to understand what determines the mental model that a particular officer uses in client interactions, and whether such model can be updated and modified through training and experience.

The strength of the performance of some officers lies in their personal interaction with their clients. It is easy to foresee that the particular interactions that officers have between them, especially in their initial socialization processes, are also likely to have a deep impact on them and determine which particular path or style they choose to take. The high degree of uncertainty and resource scarcity that shapes the environment of microcredit branches forces them to place much discretion at the loan officer level (Lipsky 1980). It is in those discrete decisions, where rules must be constantly

interpreted, questioned, and sometimes bent, that some officers achieve a performance differential. These field-level practices, which become salient in face-to-face interactions between clients and officers, have great importance both in determining MFI performance and in shaping future rules and structures. This questions research that seeks to understand MFI performance –especially if it seeks to understand its mechanisms— and focuses solely on contractual or organizational structures. The fact that rules and practices are necessarily decoupled and that rules often follow practices instead of the other way around highlights the importance of approaches that straddle different levels of analysis, to understand how structures shape interactions, and how interactions in turn shape structures (Goffman 1983).

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Conclusion

Turning Ideals into Institutions:

Implications for Theory and Practice

This work began with the broad question of what makes intentional institutional change possible. In particular, it sought to understand how actors who are immersed in an institutionalized setting can purposefully change it. The dissertation argues that previous treatments of the role of individuals –or institutional entrepreneurs—in the process of institutional change have been, at best, incomplete and can thus lead to incorrect inferences. In particular, it takes issue with two shortcomings of previous literature. The first is that traditional studies of institutional entrepreneurship tend to suffer from survivorship bias, as they start from a successful change and only trace back the successful and recorded actions that observed institutional entrepreneurs took. As a result, they do not provide a systematic understanding of the mechanisms of change, given that we do not know whether other unobserved actors performed similar actions but were unsuccessful, or whether unreported actions of the observed actors could have also accounted for the success. The second concern is that, even if observed actors were indeed fully responsible for a change, and even if their recorded actions were the true cause of that change, there remains the theoretical problem of where the institutional entrepreneurs' ideas for divergence originated. Put differently, if institutional stability is the result of convergence in beliefs of what are acceptable courses of action, then how can an actor who has been socialized into an institution conceive of a divergent path?

Through two in-depth case studies –the activation of the small business credit market and the performance of three microfinance companies (MFIs) in Mexico—I address these issues and make several contributions to the understanding of institutional change. First, I address the basic question of the origin of diverging beliefs within institutionalized settings. I incorporate theoretical insights from political science and sociology that argue that, in institutionalized settings that hinge on the convergence of beliefs, the private views of many may actually diverge, even as they publicly express their adherence to the public view. That is, there is indeed convergence in beliefs, but only in *public* beliefs (Kuran 1997; Centola et al. 2005). Given that my research design allows for the observation of a full *risk set* of *potential* institutional entrepreneurs, I empirically show that, at different points in time and in different settings, there are individuals who not

only hold private views that differ from institutionalized practices, but also have very specific ideas of how to go about changing them. Chapter 5, for example, shows how, within the MFIs that I studied, two competing institutional logics coexisted, one of which was at odds with formal rules and practices. The implication is that, within any institution, there are always several potential institutional entrepreneurs who envision change. At the same time, they are likely to keep their views private because of pluralistic ignorance (O'Gorman 1975) and the risks entailed in deviating when potential outcomes and potential costs cannot be foreseen. The finding implies that, rather than focus on who an institutional entrepreneur is, we should understand the conditions under which an individual decides to engage in a change effort and the factors that allow her to succeed.

A second contribution of this dissertation, which results from the first, is to challenge the existing conceptual framing of institutional change. Instead of envisioning change as a linear process that can be traced retrospectively, I propose to think of change as a sequence of steps that must be taken or, alternatively, as a sequence of roadblocks that must be overcome in order to successfully engender change. The argument is that change is not infrequent because institutional entrepreneurs are scarce, which is an implication of previous research. Rather, consistent with the finding that there are a relatively large number of potential entrepreneurs, change is rare because it implies a sequence of relatively unlikely events, *all* of which must happen. The focus on specific roadblocks allows us to disentangle the mechanisms that explain the conditions under which we can expect an institutional entrepreneur to emerge and to succeed. Specifically, through the observation and inductive analysis of the activation of SME lending in Mexico, I propose that there are four basic roadblocks that must be overcome in the path to change, and several mechanisms that allow certain individuals –and not others—to overcome them.

First, opportunities for change need to be recognized and envisioned. Socialization processes are powerful and, as individuals interact over time, they are bound to form increasingly entrenched communities of meaning that are high in homophily. As a result, and given processes of institutionalization, most actors within an institution are likely to, as has been consistently shown, take it for granted. Certain individuals, however, cross

borders and interact with different communities of meaning and, as a result, develop more abstract knowledge and create more diverse cultural toolkits. This allows them to remain relatively immune to socialization processes and detect opportunities and gaps that others simply cannot see. In both of the empirical cases analyzed in this work, the common factor among individuals who envisioned the possibility for change was an unusually diverse professional (and/or personal) background. This turned them into cosmopolitan actors who were able to question basic assumptions and core beliefs of different communities of meaning, as well as construct bridges between them.

Second, institutional change requires the introduction of new practices that challenge or deviate from norms. Such deviance, however, entails several risks. One such risk is that the potential benefits of diverging practices have not been tested and are thus unclear. At the same time, new practices entail set up and switching costs that are also difficult to calculate. Above these two uncertainties, however, lie the potential social costs of deviance which are impossible to foresee. That is, an individual who holds diverging private views of what an institution should be has no way of knowing how many –if any—others would support her view and thus cannot anticipate whether deviance would result in severe social punishment. Accordingly, there are two factors that facilitate experimentation with new practices. First, given the large potential costs of experimentation, individuals must have a large motivation to engage in deviant practices. In both of the studied cases, in fact, individuals who engaged in such practices were under especially large amounts of strain that resulted from the combination of broad, difficult to attain goals and poorly defined means to attain them. This strain created the motivation to find innovative –and often deviant—solutions. Second, individuals need to solve the problem of pluralistic ignorance. That is, they need to identify enough individuals who agree with –or at least understand—their diverging views to be assured that change efforts would not entail immeasurable costs. In the case of SINAFIN, for example, initial roundtables allowed potential institutional entrepreneurs to identify each other, create an initial critical mass of change agents, and coordinate to engage in collective action.

Third, institutional change is "expensive and requires high levels of both interest and resources" and is achieved when organized actors amass the resources to accomplish it through institutionalization projects (DiMaggio 1988:14). These institutionalization projects usually take the form of organizational experiments that seek to test diverging practices and explore the benefits of institutional change. In the SINAFIN case, for example, they entailed the creation of pilot products within banks to test whether SMEs were credit worthy and whether a credit product would be economically feasible. These entailed accessing slack resources (e.g. money for loans, people to grant them and collect them, etc.) and bending well established norms (e.g. taking credit risks that were not allowed by existing risk norms). Not all positions in the organization, however, allow for such levels of access to resources and discretion to bend or break rules. To successfully create organizational experiments, individuals must be high enough in the organization to access the required resources and bend certain rules but also low enough to remain relatively undetected in their divergence. As the two cases show, such a delicate balance is found in different structural positions, depending on the organization. In the case of SINAFIN, for example, it was always middle managers who were successfully able to experiment. In the case of MFIs, however, this balance was struck by loan officers at the field level.

Fourth, and finally, successful experimental results must be properly disseminated to protect them from contestation and to initialize the institutionalization of new practices. That is, successful institutional entrepreneurs must have the ability to aggregate the results of experimentation, translate them to present the potential benefits of change for different groups, and disseminate them as required to institutionalize them. This role was most clearly played by certain state-level government officials in the context of SINAFIN, who skillfully collected loan placement information from the banks and used the local business press to disseminate them broadly in order to both incite SMEs to request loans and increase competitive pressures for other banks.

Implications and Future Research

From the theory perspective, this chapter has shown that institutional entrepreneurship is prevalent, even if rarely successful; which puts into question a "great (wo) man" view of institutional change. It also suggests that intentional institutional change is a systematic phenomenon, driven by complex interactions between individuals' characteristics and their structural conditions. The finding highlights the importance of analyzing institutional change as a sequential process that is seldom fruitful because a series of relatively improbable occurrences must *all* happen, in order to dissect the conditions that explain when institutional entrepreneurs emerge and when they succeed. This means that much can be learned from failures in change efforts (e.g. Rodrik Forthcoming) and counterfactual analysis may be especially fruitful in uncovering the true mechanisms of change. Given the rarity of change, however, it raises a complexity of its own, as it requires scholars to compare successful *and* unsuccessful change efforts, with a particular focus on the *process* of change (c.f. George and Bennett 2005)

In particular, there are two findings from this dissertation that deserve more exploration. The first has to do with the idea that diverging private beliefs are a natural occurrence in any institutionalized setting, even while public views have converged and are all that is observed. A key mechanism that keeps these diverging beliefs private is pluralistic ignorance, which makes it impossible for actors to envision the potential costs of deviance. Accordingly, alternative mechanisms that allow actors to overcome initial pluralistic ignorance should be central in facilitating acts of institutional entrepreneurship. This is consistent with previous literature that shows the importance of institutionalization or organizational projects for institutional entrepreneurship (e.g. DiMaggio 1988; Colomy and Kretzmann 1995) but it suggests that the mechanisms through which these projects are affecting entrepreneurial efforts may be more diverse than previously thought. A deeper exploration of initial stages of institutional entrepreneurship could uncover different mechanisms through which pluralistic ignorance is overcome and *potential* institutional entrepreneurs become activated.

The second finding that deserves more exploration is the importance of an actor's structural position (in particular her place in the organizational hierarchy) in determining her success as an institutional entrepreneur. At issue is the fact that several mechanisms seem to be operating at the same time. That is, one the one hand, successful institutional entrepreneurs must have access to significant organizational resources lo launch experimental efforts and they must be granted significant discretion to bend or break existing rules. In general, positions that are higher in status and hierarchy would be expected to fare better in these respects. On the other hand, however, individuals must be low enough to keep their diverging practices out of view, at least until the appropriate time. Therefore, there is a delicate balance that must be struck between these different mechanisms, which would be found in different hierarchical positions depending on the organization and, especially, in the nature of the work performed.

From a normative perspective, the findings have important implications for organizations and governments. The importance of individuals with mixed professional backgrounds for the detection of environmental opportunities and the introduction of new beliefs into institutionalized systems raises questions about the hiring, training, promotion, and incentive policies that different organizations may pursue. For example, there is significant debate around the career paths that government organizations should offer their employees. In particular, the creation of civil service career systems has been proposed as a desirable tool to increase employee loyalty to government agencies and decrease their incentives for corruption. The findings of this dissertation, however, suggest that a government agency where all middle and upper management positions are filled by longstanding employees may become an encapsulated community of meaning, where new ideas or change opportunities are seldom detected (Piore 1995). Especially in cases where socialization processes are strong (c.f. Van Maanen and Schein 1979) organizations may need the integration of outsiders in order to remain innovative.

Moreover, due to the central role of norm divergence in institutional transformation, the paper raises questions about the management of deviance in organizations. While it is true that middle managers were the driving force behind all change efforts within

SINAFIN and loan officers within MFIs achieved better results through bending norms, it is also true that support –and oversight—from their superiors was determinant. This may lead us to conclude that upper management should allow norm divergence by strained middle managers as a source of innovation. However, similar mechanisms have also been shown to operate in white-collar crime and misconduct (Clinard 1983; McKendall and Wagner III 1997; Vaughan 1999). This raises questions on whether it is only certain types of divergences that should be sanctioned and the double-edged nature of deviant behavior. Even within institutional entrepreneurs, for example, not all forms of divergence may be desirable, and some may actually lead to institutional degradation instead of improvement (Farzad et al. 2007). A crucial question in this respect is what determines whether, given significant strain, a manager will engage in constructive or destructive types of deviance; as well as ways in which more constructive types of deviance can be encouraged and monitored. Moreover, these questions beg for an alternative view that takes belief (and often norm) divergence as a natural result of institutionalization and organizational processes. Such a view would allow us to more successfully explore the mechanisms that determine the path that divergence will take, given that it *will* exist; rather than focus solely on rules and structures while wrongly assuming that they will be strictly respected.

From a policy perspective, this dissertation –in particular the analysis of the SINAFIN program—raises important questions about our understanding of the process through which policies are made and the role that policymakers should play in them. It suggests that, especially in cases where policies seek to create broad institutional transformations (for example, when they seek to create a market); it is wiser to follow a process of gradual experimentation, refinement, and increasing investment rather than seek the "right" incentive alignment from the beginning. This is because, in institutional change, there is much that cannot be foreseen or anticipated and can only be learned through experimentation. It also suggests that policymakers should see themselves more as coordinators of experimental efforts and conflict mediators between all the groups that are relevant to a transformation (c.f. Fernandez and Gould 1994) than as "oracles" who must define policies in a vacuum.

Finally, the dissertation has deep implications for how we think about institutions and institutional change. Once we conceptualize institutional change as a natural consequence of social life where individuals with the potential to initiate change abound, a broad array of possibilities for change suddenly emerge and we no longer must rely on improbable exogenous shocks or the emergence of exceptional individuals to initiate it. At the same time, it forces us to develop a deeper understanding of the mechanisms through which individuals may become agents of positive institutional change. Heroes of institutional change do indeed exist, but not in the way we have typically characterized them. The true heroes of change are more abundant, but also more anonymous and much more likely to become casualties of their efforts than our traditional conception. Giving these actors voice is not only fair but also important, as it allows us to learn from their failures and develop a deeper understanding of the process of change, in the hope that, through this understanding, we will develop more effective ways to positively transform our society.

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Afterword

On Straw, Ideals, and Dissertations

During my graduate studies, the first reaction I always had when reading a qualitative dissertation –or a book that emerged from one—was a sense of sheer awe. I was of course impressed, as anyone would be, by the amount of fieldwork performed and by the appealing narrative; but what truly mesmerized me was the apparent clairvoyance of the author(s). That is, I was intimidated by the fact that the entire project (and they are usually large projects) seemed to be designed around the theoretical insights in a perfectly coherent way and I simply could not imagine ever having the vision or capability to design such a study. How were they able to always be in the right place, at the right time, to observe the interactions that perfectly addressed their theoretical questions? After my first adventure in fieldwork –the microcredit study—my reading of such works changed. It is not that I find them less appealing or admirable today, quite the contrary. What has changed is that now, in reading qualitative pieces, I am always curious about their starting point, as I have learned how meandering and serendipitous the path of fieldwork is, and how far removed the end product is from the initial plans.

In consequence, this afterword serves two purposes. The first is to act as a confession. I do not want to leave the reader (especially if the reader is a struggling graduate student) with the impression that this dissertation emerged in a coherent, ordered way and that I knew what I was getting into from the moment it began. I want it to be clear that, if there is any sense of coherence to it, it is the artificial result of endless twisting and turning of a messy set of stories. The second is to provide more information on the process through which that twisting and turning occurred. The presentation of any research, but especially qualitative research, entails the subjective filtering of information. As researchers, we may try to remain as objective and detached as we possibly can –and we certainly go to great extents to portray ourselves so when we write—but in the end we know too well that this is impossible. I therefore seek to provide more information about what was filtered and how in order to both give a more complete picture and to provide, if possible, some lessons for others who may follow. I have only worked on one dissertation (thankfully) and so it is impossible to know how much of this experience will resonate with others. To the extent that it does, however, I hope that some use will come of it, if only for others to avoid some of the mistakes I made.

An Unlikely Starting Point

In conversations with peers who do other types of research, they often assume that the most difficult part of qualitative research is the actual collection of data: all those lonely months on the field, speaking to strangers and going from one setting to the next like gold miners searching for a few nuggets buried in the sand. I have always found this assumption amusing, since it is far removed from my experience. I do not intend to say that there were not difficult moments after weeks of the same routine of waking up early, going for a run around the town I was visiting, spending six or eight hours in interviews or participant observation, coming back to an empty room to transcribe field notes, and sometimes going out again at night for drinks or dinner with informants; there were obviously many moments when exhaustion, loneliness, homesickness, or guilt about spending so much time away from my wife would kick in. For the most part, however, there is no period of the dissertation process that I found more rewarding than being on the field. For me there is something exhilarating about observing things "as they happen" and being immersed in the world. It basically brings a sense of reality to my research that I have never felt when sorting through quantitative data, regardless of their quality. Then again, like most other elements of my research, this is something that I only realized well into the process.

The fact is that I did not begin this way. I majored in Industrial Engineering, worked in the consulting industry for several years focusing on process optimization and telecommunications, and then entered business school with a special interest in entrepreneurial finance. When I graduated with an MBA and unexpectedly found myself pursuing a PhD, I thought of myself as an applied economist more than anything else. My relative strengths had always lied in the analysis of complex data, so I was naturally drawn to quantitative methods. At the same time, my college experiences working as a volunteer with indigenous groups in Mexico instilled in me a great fascination with topics of economic development and its relationship to entrepreneurship. Therefore, I had always experienced a tension between my identity as a Mexican engineer, born into a privileged family, who had mostly worked with large multinationals and my deep interest in economic development and marginalized groups. It should then come as no surprise

that, when I chanced upon a Mexican Microfinance institution (MFI) that was participating in an MIT project and offered complete access to their loan database, I jumped on the opportunity and started a research project with them. Here was an opportunity to meet a research requirement for the second year of my program, test my newly acquired advanced quantitative methods, and for the first time work in the intersection between finance, entrepreneurship, and economic development. As I began performing numerous analyses on the database, however, three events coincided that unexpectedly put me on a radically different path.

The first is that the results of my analyses on the economic impact of microloans on household incomes did not make much sense. Or, rather, they made sense but there were at least ten different mechanisms that could explain the trends I was finding. I naturally turned to existing literature on Microfinance for guidance and I was surprised both at the amount of studies that had been performed over the years and the lack of consensus among them on some of the most basic concepts. This made me start feeling queasy about the entire project, which was supposed to be a relatively simple way to meet a requirement. My next action –and the second event—was to discuss my preliminary findings (and confusion) with different members of the MIT faculty. Each meeting was slightly more devastating than the previous one. The most common reactions were puzzlement over my choice of a topic that had clearly been over-researched and had nothing interesting or innovative to offer, confusion at my lack of clarity in presenting what I was trying to study (the lack of clarity was sadly not just an artifact of poor presentation skills), and exasperation over my slow progress. I became especially worried when Lotte Bailyn, who has the amazing ability to find interesting and exciting questions in almost everything, had a combination of the three reactions listed above. At the end of the meeting with Lotte, as she was still puzzling over my results and surely trying to send me off with something positive to think about, she asked me an almost evident question that had simply not crossed my mind before: "What do *they* (the MFI managers) think is going on?" After recovering from the embarrassment of not having an answer to such a basic question, I suddenly saw a last glimmer of hope. Maybe "they" could save my project.

This, by the way, fit in nicely with the third event. I had just begun dating a beautiful and fascinating girl from Mexico who was finishing her studies in Boston and was to return home after graduation. The idea of spending time in Mexico doing further research for my project acquired a completely new dimension as soon as I learned of her imminent departure. I thus wrote an entirely new proposal that entailed spending several months in Mexico working on my analyses on-site and being close to the people who actually knew what was going on. I received some funding –on blind faith—from Rick Locke, who was my committee chair and was surely regretting my acceptance to the program. I then read as much about qualitative methods as two months allowed, I had some additional meetings with relevant faculty –John Van Maanen and Lotte Bailyn were especially impactful—to prepare me for the field and was on my way.

Given my own confusion about the topic, I began my work in Mexico with a broad, apparently straightforward question: "*What makes microcredit work?*" I figured I would start with this and then narrow it down as answers emerged that resonated with my quantitative analyses. Exactly the opposite occurred. First, during my initial interviews it became apparent that managers had at least three or four definitions of what "success in microcredit" meant. For some, it meant profitability. For others, it meant positively impacting their clients. For yet others it meant international exposure and access to donor funds. All of them saw some loose linkage between the different metrics of success, but not more than that. Second, as my number of interviews increased, a first pattern of answers began to emerge that was contrary to my initial hypotheses –and to what most of the literature had led me to expect. Where most of the literature focused on contractual structures and broad organizational or environmental features, interviewees emphasized differences between specific branches or specific loan officers and their practices as examples of what success meant. They could not clearly articulate what it was that made some more successful than others (or what more successful *really* meant) but they were clearly convinced that the answer lay in their particular skills and practices. Going back to the quantitative data showed that, not surprisingly, the interviewees' perception on the

large differences between branches and officers along different metrics was absolutely right.

It was thus that, after a full month of interviews, what I had originally viewed as the last phase of my research project became only its beginning. I realized that I had been focusing on a poorly defined dependent variable, using the wrong level of analysis, and seeking to oversimplify a phenomenon that was much too complex to water down. I wrote a new research proposal based on a radically different research design and level of analysis. I also learned a big lesson of qualitative work: doing fieldwork is indeed like going down to the source and learning form the people who "know what is going on". However, it also means drinking directly from the fire hose. Social phenomena present themselves in their full, messy, overdetermined nature and actors who live in them are no better than the rest in articulating what is driving what (but if you push them they *will* try), even though they may have a clear intuition of where to go looking for it. It is akin to searching for an especially hidden site inside a forest: most of the people who have seen it would not be able to draw a map or write directions to it, but many could certainly take you there.

Another related lesson that has proven useful was the importance of having a broad research question. On the one hand, the question was broad enough –"what makes this work?"—to grant me flexibility and let my fieldwork define what the specific dependent variable should be, as well as the subsequent research design that would best address it. On the other hand, I would personally find it hard to jump into a field study without a research question, however broadly defined. I have seen peers attempt this and access rich field settings with the hope that such richness will throw a clear research question at them through "letting the data speak for themselves". The problem I find is not that the data do not speak, but that they tend to speak too much. Rich settings provide an endless array of stories that point in tens of directions. I do not believe I have the capability or the self discipline to discern, while immersed in an exciting setting, which direction is potentially more fruitful or interesting. In that sense, I am convinced that the research methods should follow the question and not the other way around. For me, the pursuit of

qualitative work has emerged from a sense of restlessness and discomfort with existing explanations of a particular phenomenon, and from the conviction that a key element – that is not identified—is missing and thus needs to be discovered.

A broad research question then initiated my quest, even though the actual dependent variable and full research design may not have been evident. This broad start –in both research projects—forced me to seek informants who knew the phenomena at different levels of analyses and who could be considered "experts". They had walked the forest long enough to know their way around and recognize which trees not to bark up. Observing them as they walked through their forest provided a better understanding of what a tractable dependent variable would be and the appropriate level of analysis. This required much patience and letting enough people –from different sides—tell their particular stories so that a clear pattern on the level at which they explained the phenomenon began to emerge. As soon as the new dependent variable and level of analysis emerged, I stopped to revisit the research design to let it explore the stories as they were being told.

This strictly contradicts what I have often heard some peers assume in the sense that qualitative –mostly ethnographic—research does not require a sturdy research design since it entails "telling stories" and letting the data "speak". In fact, effective qualitative studies are no different from their quantitative equivalents in the care with which they were designed. What is different, however, is the fact that the research design is in flux and only emerges after several stages of the research. Erving Goffman's "Asylums" is a case in point. The book is so effective because of its brilliant design. It takes the most critical case of a total institution, where actors are not only stripped of their identity upon entry but also have a potentially weaker sense of self to begin with. Goffman then goes to show how, *even there*, actors find the need to "negotiate an identity" and follow rational patterns in the construction of such an identity through their interactions. He did not develop his concept of negotiated identities because he studied the asylum. He studied the asylum because he sought to understand (and to convince others of it!) how identities emerge.

Getting Started

Once my research design became clearer I knew *who* I wanted to observe, but I did not know *what* I was trying to observe and "everything" seemed too broad an answer. That is, I finally had a clearer sense of what my dependent variable should be. Not so for the "right hand side" of the equation. In addition, this new stage of research, which entailed spending time in remote MFI branches and intensely interacting with clients, presented its own challenge. My understanding of participant observation required the researcher to "blend in" with the observed group, becoming one of them to observe interactions as they "really" happened. My first visit to a client made it patently clear that this would be impossible. As I walked into a crowded, noisy indoor market with a loan officer by my side, I saw a significant proportion of the heads inside turn towards me and a brief period of silence ensued. After a few –very long—seconds they all resumed their activities, but I could still see people eyeing me briefly with a mixture of curiosity and suspicion. While I am Mexican, born from Mexican parents, I have light skin and dark blond hair. Practically every person I interacted with for the study (clients and loan officers) was dark skinned and had dark hair. I was raised and educated in a completely different environment from these people and my language, my demeanor, and every gesture I made was completely different from theirs. Those first moments in the market confirmed my fears of sticking out too much to ever be considered "an insider". I was terrified that I my status as an outsider would preclude me from ever witnessing a real and revealing interaction.

Gladly, this fear soon dissipated. It was so obvious that I was an outsider that I did not even engage in efforts to fit in, which turned my full attention to the people I was observing. For the most part, people were amused by my interest in them and their activities. I decided to open myself up to their questions at the beginning of my observation periods to clear any lingering curiosity that could affect the ensuing interactions. Standing out gave me the added benefit of legitimately claiming absolute ignorance about everything I was observing, and no question was too stupid or too evident to ask. More fundamentally, however, it became clear that after initial questions and a half an hour or so of my presence, people for the most part forgot that I was there;

they went back to their activities in a normal way, presenting me with much to observe, even if it was yet unclear what I was looking for. In the epilogue to "Street Corner Society", William Foote Whyte writes about his struggles with participant observation, in particular the notion that a researcher should "observe in order to observe". It only made sense to him –and to me—after much time had been spent in observation and a particular interaction provided a minor epiphany. It is also fitting that I mentioned Goffman's notion of negotiated identities and the importance of the interaction order above, since these were also concepts that I had enjoyed reading about but that had not at all resonated with me until that particular interaction occurred.

I had spent enough time observing loan officer interactions with their clients to notice that each loan officer had a personal interaction style, and that styles ranged from deeply personal to strictly institutional. The personal style of a loan officer seemed to be somewhat related to loan outcomes but I could not quite grasp how. On one occasion, I had spent an entire morning visiting a client. She was the embodiment of a microcredit success case. She had no formal schooling beyond primary school and began working as a seamstress at a young age. She learned the trade successfully and saved until she was able to buy a single sewing machine, thus becoming an independent contractor for outsourcing companies. Through the efficiency and quality of her work she soon had more requests than she could handle, and hired her sister to help. She obtained a first microloan and purchased a second sewing machine. This pattern continued until the time of my interview with her, when she managed dozens of employees and owned a similar number of sewing machines. Furthermore, she was working on her own designs and was commercializing them directly, since "outsourcing does not pay well." Both in her conversations with me and in the interactions I observed with her employees she came across as an extremely able, secure, and strong-willed woman who knew exactly what she was doing and had a firm sense of authority to back it. When the lunch break began, she mentioned she had to go to the MFI branch to discuss some issues around her loan (now a significant amount relative to typical loans) with her loan officer. I decided to accompany her. As we entered the branch and before my very eyes, this person went through as dramatic a transformation as I have ever witnessed. The strong, articulate,

secure woman I had observed all morning suddenly became a quiet, stuttering, insecure client who cringed at every question posed by her loan officer. Only an actual loss in physical height would have been more dramatic to observe. It is not that she had things to hide –she was a good client, in good standing. She was simply so intimidated by the formality of the MFI branch building and the language the loan officer was using to address her that she was clearly insecure about how to act. On the other hand, the loan officer seemed completely oblivious to this. It struck me that all the loan officer could ever observe was this "version" of the woman, which surely affected both his image of her as a client and how future interactions were constructed. In addition, because both the loan officer and the client were unaware of this transformative effect, there is no question in an interview that could have brought this to light. Only the observation of the *actual interaction* could. I was shocked that the loan officer's demeanor could so drastically transform a person, and the rest of my study revolved around the effect that loan officers, and their interaction style, could have on their clients.

As I continued immersing myself in this world and established a few stable relationships with some key informants (both clients and loan officers) new challenges emerged. One of the most difficult things was to decide how much emphasis to put on each of the two words "participant observation". Quite often, for example, clients would ask me for advice on their business decisions. Should I provide advice? Should I point out mistakes they were committing when storing certain products? Should I raise potential health hazards in their operations? Against my initial instinct, the answer most of the time was no. I realized that my role as an observer precluded me from affecting their activities, at least on the immediate level. That said, on some occasions I would provide minor advice based on "best practices" of other clients I had observed, but never more than that. Also, whenever possible I would physically help my subjects in their activities –carrying a load, or collecting payments for transactions, for example. The most difficult decisions, however, came when I observed clearly unethical or damaging interactions. This was especially difficult given how vulnerable clients are relative to loan officers or MFIs. On one occasion, for example, a loan officer suggested to a client who was struggling with her payment to borrow money from a moneylender in order to repay the MFI. I learned of

several loan officers who engaged in this type of behavior, some of them even receiving side payments from moneylenders. Much to my chagrin, I often had to keep these interactions to myself because I was bound by promises of confidentiality, and I could only raise the issue as a general problem to higher managers. I would then be mortified for days on end about my decision. That said, there were two instances where I learned of these issues directly from clients –without the presence of their loan officer—and, after obtaining the client's consent, I directly raised the issue with branch managers or supervising managers, only to be equally mortified by the potential ramifications of my interference.

After several months in Mexico (during which, by the way, I managed to become engaged to the girl I was dating), my funding was running out and it was time to go back to my graduate courses. These binding constraints proved useful in two related ways. First, from the beginning of my fieldwork I was conscious of the end point, and it forced me to remain productive and attentive. Second, and more importantly, I did not have to make the decision of when to stop. As I later learned during my second research project, the more time one spends on the field, the more comfortable it becomes and the less clear it is when "enough" has been collected. The patterns become so familiar that they no longer seem interesting enough and there is an urge to observe additional nuances, gain additional insights, and find additional sub-patterns. An external limit spared me all these questions. This brings me back to the question of the hardest part of doing qualitative work. As I said before, for me it is not the time spent on the field. The hardest part for me begins with the decision to return and with the process of turning a complex, overdetermined, messy set of stories into a somewhat coherent narrative. This entails creating an artificial sense of linearity to communicate insights in a digestible way. It also entails a difficult process of filtering through stories that all seem interesting to only pick those that convey the key theoretical concerns without biasing the overall picture. It is here that I find the largest challenges and I must confess that I am yet dissatisfied by the current narrative of this thesis. I am sure that the months that follow this afterword will be spent revisiting and rewriting most of the work obsessively.

Moving Up in the World

My experiences researching microcredit had a profound impact both in how I thought about research and in my view of formal structures, rules, and norms. In particular, I became quite interested in the fluidity of norms and how they shaped interactions that later also shaped those norms. Once I finished my coursework and passed my qualifying exams, it was time to define my next research project. I decided to look for settings where I could study the interaction between norms and practices clearly, and I figured the best way would be to observe the process of a broad institutional change. I found the idea appealing because I thought the process of change would bring the contradictions between formal and informal rules sharply into relief. At the same time, I was still committed to the topic of economic development and entrepreneurship, and I wanted to find a setting where these topics would remain relevant.

I therefore spent two months in Mexico evaluating different potential research sites and trying to negotiate access to them. I only knew that I was looking for a setting where broad institutional changes were in process, but had little else to go by. For my first set of meetings I therefore visited my old consulting contacts (some of whom had moved up in the world and were now managing several projects simultaneously), as they both knew many people in a wide array of organizations and had a better sense of general trends in the Mexican economy. Using the typical snowball approach, my initial contacts gave me a new set of people who were positioned in the boundary between the private and public sectors, and who had a good idea of broad institutional changes that were occurring. This second round of meetings helped me identify –to my surprise—four promising institutional changes in process. One was the SINAFIN program, which I studied. The second was the transformation of the Mexican mortgage market which was going through its most sweeping stage. The third was the transformation of the government's popular savings infrastructure. The fourth was social security reform. Personally, I initially found the second and third settings most appealing. There had been much press on the broad transformations of the mortgage markets and I was well aware that this had entailed the creation of new markets –secondary financial markets, for example—from scratch. An additional attractive feature was that it had involved deep transformations in some of

Mexico's most traditional corporatist structures (labor unions) and their clientelistic networks. On the other hand the popular savings reform also had attractive features. It involved a population that I had come to understand relatively well and become attached to with the microcredit research. It also entailed the creation of a new market exchange, as it grouped thousands of popular savings organizations from across the nation into a single exchange. Finally, it too had involved changes in deep rooted political structures. Both of these potential settings were touted by government officials and think-tank managers as highly successful, and they both clearly had positive political momentum even if they were still in flux.

The SINAFIN program, as I described in the dissertation, also had many of these positive features, but I was less attracted to it for several reasons. First, it was not as well known as the other two, and my initial informants were much less enthusiastic when talking about it. Second, it was clear that it was lacking political momentum and it was not at all certain that the program was going to succeed. Third, the program was operated through the national banks. This meant that I would have to spend substantial time doing fieldwork in organizations that I had always perceived as extremely boring and unattractive. Ironically, and as I will describe later, these drawbacks later became the very strengths of the research setting.

Once I identified these four candidates, I tried negotiating access to them. Given that authorization would have to be given by top officials, I decided to try my luck and start there. To my surprise, the heads of three of these four settings (the Minister of the Economy; the CEO of INFONAVIT, the government mortgage agency; and the CEO of Bansefi, the popular savings agency) responded quickly and granted me appointments to discuss potential access. I initially met with the CEOs of INFONAVIT and Bansefi, but had a particularly interesting meeting with the former. He seemed excited to have an external researcher document the changes that were occurring, and as an economist was intrigued by the idea of qualitative methods. I was tempted not to pursue the Ministry of the Economy further given my success with INFONAVIT, but out of thoroughness I decided to pursue the initial meeting. It was a disaster. The office of the Minister decided

that I should meet with the Sub-Minister in charge of SINAFIN, who naturally had an extremely busy schedule. A meeting was set for two weeks after my other initial meetings, and I flew back to Cambridge to discuss my potential sites with my thesis committee. When the date of the meeting came, I flew to Mexico again, only to find out upon arrival to the Ministry that there had been a last-minute cancellation. I was extremely disappointed and annoyed, to say the least. I walked out convinced that INFONAVIT would be a much better choice, and made an appointment with the CEO to discuss next steps.

That afternoon, however, I received a call from the Managing Director of the SINAFIN program. He had heard of my interest to study the program through the Sub-Minister's assistant, and was deeply embarrassed by the last minute cancellation. He asked me to come into his office the next day. During that two-hour meeting it became clear that he was the person truly running the program. Moreover, he was extremely interested in my study of the program. He explained the political resistance they were facing and the critical moment the program was going through. Furthermore, he explained the remarkable successes they had achieved. Having an external researcher evaluate the program was extremely attractive for him because it would document everything that had been done and would provide him with an additional tool to defend the program against further political attacks. More importantly, it would help him *understand* the program. To my puzzlement, he explained how they had been much more successful than they had hoped to be, *especially in some states*, but the Ministry had absolutely no idea of why they had succeeded beyond expectations. As a former academic (he had a PhD in Sociology from the University of Wisconsin, Madison), he was puzzled by this and was sympathetic to the approach I was proposing to study it. He offered his full personal and institutional backing (he even offered some funds, which I declined on the grounds of maintaining full objectivity and independence) and was eager to begin the work immediately. It became clear that the enthusiasm, level of access, and institutional backing the Ministry of the Economy could provide was far superior to my alternatives and I jumped on board with them. In exchange for full access to program data and to every person I wished to interview or observe, I would provide them with a full report of

my findings, including a chronology of the program, its key results, and the best practices I identified (similar to chapter 3 of this dissertation). This would serve as an "Institutional Memoir" (their words) for them.

This experience gave me two additional lessons, which were reinforced at several points of my fieldwork. First, gaining access to an interesting setting often entails making yourself useful and providing –to the extent that the work and ethics permit it—interesting, insightful information to the gatekeepers. I have been increasingly surprised by the lack of reflection that occurs in most organizations, mainly due to the burdens of day-to-day operations. Providing the gatekeepers with a fresh, insightful, informative perspective of their organization and giving them a feel for "what is really going on out there" is extremely useful and attractive, and is a relatively costless (aside from the time it takes to prepare memoranda) way of gaining and maintaining access to interesting settings. Maintaining a constant, close contact with these gatekeepers by keeping them informed both of the status of the research and of the "nuggets" of information that emerge is a way to ensure continued support and increased access. At the same time, it is extremely important to handle expectations properly. When I was asked to write the final report in exchange for full access, I was worried that they would expect either a falsely favorable view or the sharing of privileged information that I learned along the way. I spent several weeks negotiating the exact content of my periodic and my final reports, making sure that I would not be expected –or pressured—to deliver more than I would be ethically or physically able to provide. This entailed often pushing back –sometimes strongly—on certain requests (for example, giving them insights into my interviews with their political adversaries). At the end of each pushback, however, I felt that I had further gained their trust and confidence in my professionalism as a researcher.

The second lesson is that it is important to always have several leads into the same question, and remain open as new options unfold. At the moment, my lost meeting with the Sub-Minister seemed like a catastrophic event. Missing that meeting, however, was a crucial turning point for the dissertation, as it opened the door for my meeting with the program manager. Looking back, it is clear that the other research settings would not

have been able to match the level and quality of access I had with SINAFIN. A similar pattern emerged with potentially fruitful leads for interviews that did not come to fruition. My first reaction on a lost lead was always to become frustrated and fear that I would miss a critical part of the story. In my correspondence with John Van Maanen, however, he always reminded me that, "if it is important, it will happen again many times."

Moving On

The rest of the SINAFIN research followed a similar pattern to my previous experience with microcredit, but at a much larger scale. Most of the conundrums and the issues I encountered were similar to the ones I have described above, only larger and for longer periods of time. The end point for this work was marked not by funding limitations or by degree requirements, but by a wife (now living in Boston again) who was increasingly frustrated by my constant traveling and the elections in Mexico that first brought significant political turmoil and then shifted the priority of every government agency into the presidential transition. The presence of my wife in Boston was a mixed blessing. On the one hand, it meant that I had to constantly travel back and forth between the countries, spending some time in Cambridge for every period I spent on the field, which proved to be more exhausting than I could have imagined. On the other hand, these trips allowed me to periodically take a step back from my data and see it all in perspective before immersing myself again. These periodic pauses proved extremely useful in sorting through the stories and finding the most relevant patterns.

As this dissertation comes to an end, the reader may be wondering what has changed, if anything, in the settings I described here and what impact my research may have had in them. On the microcredit side, I am afraid that I do not have positive news to report. The insights of chapter five would indicate that MFIs should spend much more time hiring and training their loan officers to turn them into better decision makers who can positively use their discretion to positively impact clients. There are two trends, however, that are pushing MFIs in exactly the opposite direction. First, there is now fierce competition among MFIs in Mexico, and they are all increasingly competing for the same

pool of clients. As a result, there is a significant amount of employee turnover as rival MFIs poach loan officers from each other, which reduces the embeddedness that officers can have in their organizations and their coverage areas. Second, and related, competition is creating much pressure to increase returns and cut costs. To achieve this, many MFIs are increasingly pursuing credit scoring and parametric lending, which implies further distancing the client from the MFI, and making all lending (and collecting) decisions based on purely quantitative data. I fear that, on the one hand, more destitute clients will increasingly face anonymous collectors who do not register the negative impacts of their actions on potentially good clients. On the other hand, I also fear that increased competition for the same clients, coupled with a detachment from the local market and a lack of communication between competitors will only speed up the process of over-indebtedness of the more destitute clients. These market trends are quite real, and at this moment it is a hard sell for an MFI to increase their costs of loan officer training and supervision.

On the SINAFIN side, the news is more balanced. SME lending has indeed taken off, and there are increasing numbers of banks and non-bank intermediaries who are active in the market and who are innovating with new credit products and lending methodologies. There obviously remain many structural barriers that need to be overcome, such as certain legal gray areas, but there is now enough market pressure and a critical mass to believe that things will continue in a progressive path. On the other hand, the news for the particular individuals of the study is not so positive. First, as I mentioned in chapter 4, many of the most active change agents became casualties of their own success as more powerful actors pushed them aside to appropriate their efforts. Second, as the political momentum for SINAFIN and the Ministry of the Economy began to shift, and given the relative weakness and lack of structure of the Ministry, the presidential transition was followed both by an increase in the budget assigned to the programs and by significant turmoil and internal sparring over the control of these resources. It is difficult to foresee what will result, but in the meantime the Ministry, for all practical purposes, has not operated any programs in the last 18 months and has lost most of its political momentum and support from other relevant actors. When I talk to some of my closest informants and

we discuss the current situation, there is an increasing sense of frustration over lost opportunities. They all seem to believe that the most important lessons the Ministry could have learned from their success with SINAFIN revolved around a much more integrative, iterative, experimental, and open process of policy design and implementation. The current inactivity of the Ministry –even as its budget is increasing—and the absolute lack of communication with other actors on what the new programs and priorities will be do not resonate well with these lessons, and have us all hoping that the new Ministry team has taken these steps back only to more forcefully push forward.