The Commercialization of Microfinance in Latin America

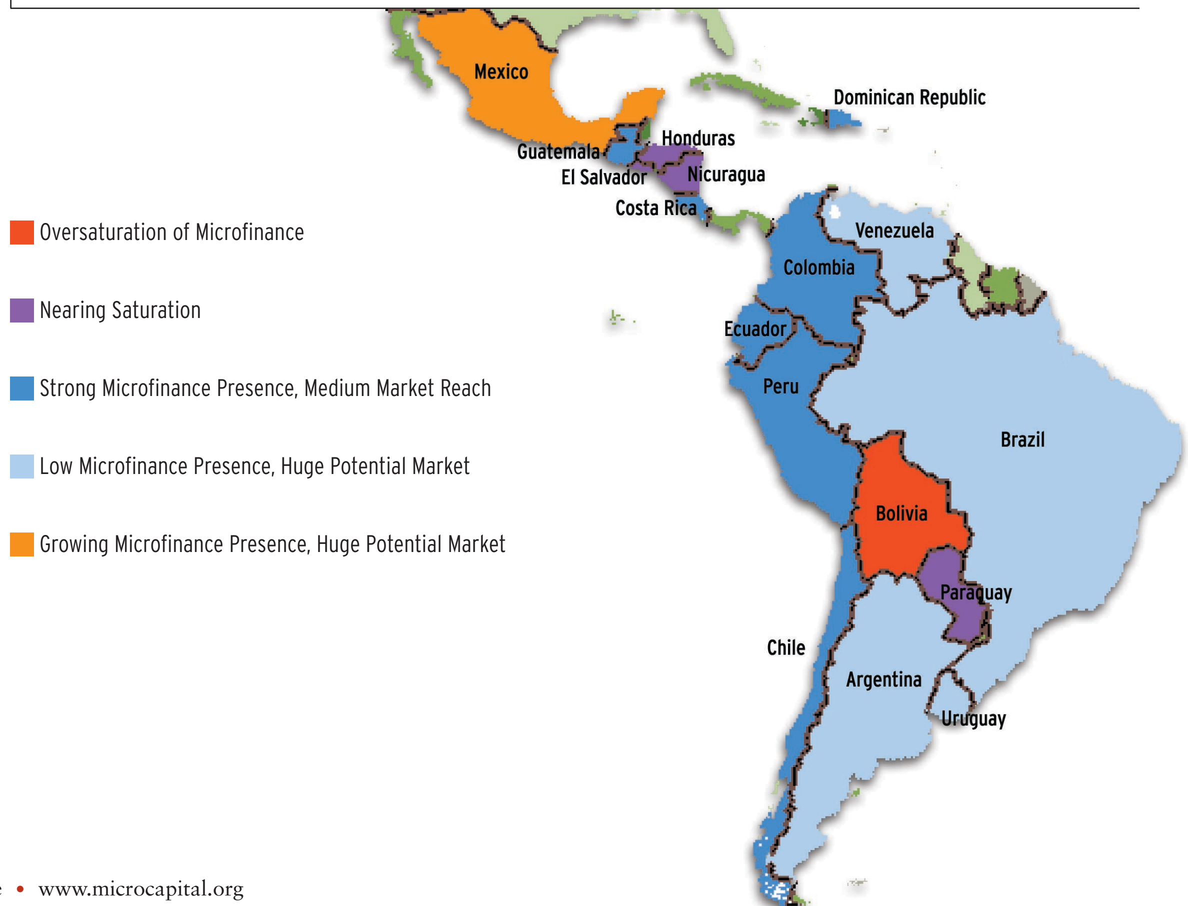
Introduction

Microfinance in Latin America has been characterized over the years by a clearly profit-driven and competitive landscape that differs widely from the peer-group style lending championed by Grameen Bank of Bangladesh and other Asian and African models. It's a model that has had success in alleviating poverty in the region, helping to develop Third World economies and, more recently, creating a new asset class for private investors interested in a social return as well as a financial return.

"Latin America is the most commercially advanced microfinance market in the world," says Roy Jacobowitz, vice president for resource development at ACCION, one of the world's largest microfinance institutions.

Lately, however, microfinance in Latin America has been plagued by problems that threaten to derail both its social agenda and its all-important access to capital. Among those problems are market saturation in some areas, mission drift, regulatory hurdles, and a lack of adherence to accounting and financial reporting standards. Another major problem is a tendency by microfinance institutions (MFIs) to focus on the smaller countries of the region and on dense urban areas instead of the big nations and rural areas where a large part of the unbanked poor reside.

This paper focuses on those problems, and the possible solutions that the commercialization of microfinance can provide – if the industry is properly structured and developed by the players involved and those that seek to regulate it. This paper also examines the types of microfinance models, the institutions, and the growing sources of capital available for microfinance in Latin America.



Background

While microfinance in Latin America had its roots in locally initiated projects in Bolivia back in the 1970s, its growth during the 1990s was mostly characterized by the presence of foreign non-governmental organizations (NGOs), working with local government institutions to develop individual and peer group-based lending schemes.

Prior to 1990, virtually all microfinance lending in Latin America was from taxpayer dollars. About half of that was from foreign sources – multilateral institutions such as the UN, the World Bank, Inter-American Development Bank and the European Bank for Reconstruction and Development, as well as national development agencies such as Germany's Kreditanstalt für Wiederaufbau, the Swedish International Development Corp., the Japan Bank for International Cooperation and the US Agency for International Development. The other half was from local governmental and quasi-governmental organizations such as national development banks, social ministries and state-administered social funding organizations.

In the early 1990s, private investors began to become involved in microfinance in Latin America. This was the result of higher demand from loan recipients and inadequate funding on one hand, and a fresh supply of private capital looking for investments with a social agenda. Since 1998 virtually all of the growth in the microfinance industry in Latin America has been fueled by private investment. Public funds, both from local and foreign sources, peaked in 1999 and have since actually declined slightly, while microfinance capital from private sources has been growing at more than 50% a year, according to studies conducted by the MicroCapital Institute. The Consultative Group to Assist the Poorest now estimates total worldwide microfinance loan volume at more than $3 billion.

The supply side has fueled much of that growth, as the slowdown in world equity markets and a search for alternative investments has prompted more private investors to look at microfinance. But the institutions have also fueled that growth, as commercially driven microfinance banks and finance companies have begun to dominate the microfinance landscape, at the expense of NGO models (more on that later).

Types

As microfinance has grown, so have the types of institutions administering microcredit in the region. It's virtually impossible to place many of these institutions into one category or another, as there is substantial overlap. However, they can be generally broken up into five main groups: Commercial Banks and Consumer Finance Companies, Regulated Microfinance Banks, Credit Unions and Cajas, Regulated MFI NGOs, and Non-Regulated MFI NGOs.

♦ **Commercial Banks and Consumer Finance Companies**

The commercial banking sector in Latin America has gone through tremendous transformation over the past 15 years, as an initial wave of privatization of state-run banks gave way to a second wave of mergers and acquisitions by foreign banking institutions. Initially, those changes led to a reduced amount of what would by most accounts be defined as microfinance – small business and individual loans of less than $1,000. Foreign banking institutions were first interested in stabilizing an overextended and inefficient banking system.

Now, however, with most of the large banks in the region on stable footing and ownership structures, the large banks have begun to get back into microfinance, often recognizing its profit potential. Some of the largest, such as Spain's Banco Santander, are opening microfinance operations in several countries.

To other commercial banks, microfinance is nothing new. For Banco do Nordeste in Brazil, for example, providing lower class entrepreneurs in both urban and rural areas with consumer credit has been a foundation of the bank for years. Indeed, credit cards have become a way of life among much of Brazil's lower-class population – a fact which has created separate problems of overindebtedness and a need for stricter regulation.

> "Since 1998, virtually all of the growth in the microfinance industry in Latin America has been fueled by private investment."

♦ **Regulated Microfinance Banks**
As microfinance has grown, both the institutions and the governments that oversee them have seen a need for new regulations that allow MFIs to be lifted to a higher level that allows the MFIs to offer more products on a wider scale while also providing more oversight and enhanced capital requirements – though sometimes on a somewhat more flexible scale than a regular commercial bank. Examples are BancoSol in Bolivia, MiBanco in Peru and Finansol in Colombia. All of these began as non-bank MFIs, but their status as commercial microfinance banks has enabled them to access both public and private funds from foreign and domestic sources on a level that most NGO MFIs haven't been able to match.

♦ **Credit Unions and Cajas**
While credit unions and cajas are often synonymous in Latin America, there is sometimes a differentiation as a "caja" is often more akin to a savings bank rather than an institution that is set up to administer loans. Nonetheless, for the purpose of this paper we are grouping them together as one group of regulated financial institutions that take in savings and dole out small loans to lower and middle-class clients. Cajas are often either government owned or were previously government owned, either at the municipal, state or federal level, and have since been privatized. They fall under separate laws from the banking system, but usually have to meet certain reporting standards and capital requirements. Throughout Latin America, these are among the widest sources of microcredit.

♦ **Regulated MFI NGOs**
The vast majority of foreign-owned MFIs operating in Latin America, as well as a growing number of locally owned MFIs, fall under the umbrella of regulated MFI NGOs. These include such large and well-funded organizations as Women's World Banking and Compartamos, as well as smaller, targeted institutions such as ProMujer and Village Banking. Some of them have their own sources of capital, while others rely on donations and loans from private and public sources. A very few are able to exist solely on the basis of their own revenue.

♦ **Unregulated MFI NGOs**
While decreasing in number, CGAP estimates that unregulated MFI NGOs still make close to 25% of all non-bank microfinance loans in Latin America. These mostly cater to the most impoverished sectors of society that many other MFIs won't touch, with loans of $100 or less. Their funding usually comes in the form of grants and donations. Often, their unregulated status is a result of regulatory structures in some countries that make it cost prohibitive to apply for and maintain a license. At times, governments turn a blind eye to their existence due to the good that can come from them – but that attitude is increasingly changing as governments seek to control all activities that include credit.

Group vs. Individual

As microfinance in Latin America has become increasingly commercialized, there has been a steady migration of microcredit away from the time-honored group and peer lending programs toward more individual loans. This migration is a fragile issue among the lenders themselves. On one hand, retaining peer-group models can lead to increased repayment rates as loan recipients feel the pressure of community involvement and are more apt to repay loans. On the other hand, it's difficult for lenders to measure and quantify that peer pressure. And as more lenders seek commercial funding, they are pressured to come up with credit scores and repayment risk estimates that only work on an individual basis. The challenge for microcredit issuers in the region is to achieve that migration without increasing default rates.

"When we talk about commercial microfinance in Latin America, we are no longer talking about the Grameen Bank model of peer lending. This is not the level where investors play," says Kendall Mau, vice president at Prisma, a Boston-based MFI and fund that operates in Nicaragua and Honduras. "It's no longer about solidarity groups. It's individuals who come to your office to get loans."

Competition and Market Differentiation

As commercialization increases, so has competition. Five to 10 years ago, there was a seemingly endless horizon of clients in need of micro loans throughout all of Latin America. In some countries, however, that horizon has shrunk considerably. In Bolivia especially, and increasingly in Nicaragua, El Salvador, Honduras and Paraguay, MFIs are often reaching out to micocredit clients only to discover that they are already indebted to one or two other MFIs. This has fueled over-indebtedness in those areas and created a sharp need for consumer credit profiles and standardization of lending policies.

In another set of countries – Colombia, Peru, Chile, Costa Rica, the Dominican Republic, Ecuador and Guatemala – microfinance has been taking hold and reaching anywhere from 20 to 40 percent of potential clients.

The majority of potential microfinance clients in Latin America, however, are within four countries in which the market is vastly underserved – Brazil, Venezuela, Uruguay and Argentina. In these countries, microfinance reaches only a small fraction – generally less than 5 percent – of the potential market. The main reason behind this market differentiation is cherry picking on the part of the MFIs. They tend to favor countries where microfinance is already established, governments are cooperative, and access to clients is easy. With the

exception of Uruguay, the sheer size and population distribution of the most underserved markets is a major barrier to penetration. But it also presents a huge opportunity for commercially driven microfinance enterprises with the efficiencies and financial backing to penetrate these markets.

In Brazil, the vast Northeast and Amazon regions offer huge pools of potential clients. Here, only Banco do Nordeste has made a significant dent, using a combination of consumer credit and microcredit instruments. It has had little competition from foreign-based MFIs. Indeed, even with competition, the market is so vast that it would take years if not decades before it hit the saturation point of countries like Bolivia and Nicaragua.

"The Northeast and the Amazon absolutely require microfinance," says ACCION's Jacobowitz. "There is a huge impoverished population that is not being served by consumer credit. Still, there are huge scale problems and regulatory problems to overcome."

In Brazil's South, especially in and around Sao Paulo, one of the world's largest cities, microfinance per se is but a drop in the bucket. Consumer finance companies dominate the small loan business, and have penetrated to low-income clients that consumer finance companies in other countries would never dream of touching. As a result, they are often in direct competition with microfinance. The repayment rates are fairly stable. This is a cultural phenomenon that is unique to Brazil, which consistently ranks as the country with the largest number of entrepreneurs per capita in the world. Individual – as opposed to peer group – loans work well in Brazil because the drive to succeed and lift one's social status is high.

> "MFIs tend to favor countries where microfinance is already established, governments are cooperative, and access to clients is easy."

However, that's not to say that microfinance isn't needed in Brazil's South. Indeed, consumer finance – aka credit card debt – is not the best way to start a business in Brazil any more so than it is in the United States. It fosters overspending and often leads to over-indebtedness, while microcredit typically encourages discipline in both spending habits and repayment.

Mexico is a separate case. Microfinance there reaches less than 10 percent of the potential clients, and yet the infrastructure being developed by institutions such as Compartamos, with its 300,000 plus clients, is quickly expanding. Within five years, Mexico's microfinance industry is estimated to reach 30% of the potential clients – virtually all of it with commercially driven individual loans.

Reporting and Financial Standards

One of the biggest obstacles to expansion of microfinance in Latin America is the lack of reporting, financial and accounting standards. This is quickly changing on the MFI level, as lenders are realizing that in order to seek private capital they need to meet certain international standards.

"If the entity itself can't come up with international banking standards, you are going to have very few international investors that will put their money in," says Prisma's Mau.

Rating and auditing agencies are quickly working to solve some of these problems, and are reaching out to MFIs around the region. Washington, D.C.-based MicroRate, for example, has been retained by dozens of MFIs to provide in-depth analysis of their finances and accounting standards that, in many cases, matches the reviews done by bank rating agencies.

One problem, however, is that this level of oversight often does not extend to the international funds that invest in these MFIs. While there are exceptions, most microfinance funds – which are usually the only link between the investor and microfinance – are not rated and do not routinely report financial performance. More and more, however, the more commercially driven of these funds are seeing the need to do so.

Regulatory Hurdles

One large obstacle to the expansion of microfinance in Latin America is a lack of regulatory infrastructure that allows microfinance to exist and flourish. While some countries have enacted specific microfinance laws to provide more flexibility to the sector, most MFIs are still faced with the key decision – to be or not to be a bank. If they choose not to be a bank, they are usually prevented from taking in savings and face other restrictions on their operations and types of financial products they can offer.

The decision to become a bank, however, usually requires a substantial investment – often $5 million to $10 million in capital – before an MFI can even apply for a banking license.

Another challenge is the lack of appropriate regulation. For microfinance to flourish, Latin America is going to need to move toward more flexible laws that encourage government oversight over MFIs while at the same time allowing the MFIs flexibility. Stricter but market-oriented regulation can improve the transparency of the microfinance industry and encourage more private investment.

Increasingly, the lack of a proper regulatory environment is leading to market segmentation, giving an edge to the large microfinance banks such as BancoSol and MiBanco as well as some large, regulated MFIs such as Compartamos. Such institutions are finding it easier to both operate and to access capital, at the expense of smaller MFIs.

Mission Drift

A final problem for microfinance in Latin America is mission drift, and it's a problem that will continue to face the sector as it becomes more commercialized. As MFIs grow and seek private capital, they inevitably increase the size of their average loan. Commercially driven MFIs now have an average loan size of more than $800, while MFIs that rely only on public funds tend to issue loans ranging from $100 to $500.

Interest rate differentials are also prompting mission drift. Purely commercially driven MFIs by their nature will set their rates according to what will bring in the most profit. Often that means rates exceeding 100 percent. Purely socially driven MFIs, on the other hand, set their rates according to what will be most helpful to ensure the success of the recipient's venture and help him or her emerge from poverty.

Usually, the reality is somewhere in the middle. But going forward, commercial microfinance institutions will need to be careful not to allow high interest rates and high loan sizes to thwart their social mission. In the end, most private investors are going to look at microfinance both for its social as well as its financial return.

It's a Catch-22, says Lynn Patterson, executive director of Pro Mujer, a New York based MFI with some $10 million in loans to 96,000 clients in Bolivia, Nicaragua, Peru and Mexico. "MicroRate says our return on investment is too low in Bolivia. But we don't want to raise our interest rates."

"Interest rates in Latin America are much higher than they are in Asia at places like the Grameen Bank, but in Latin America the costs are higher too," Patterson says. "You can reach a mass market easier in Asia. It's much more dispersed in Latin America."

Conclusions

Our portrayal here of the problems that microfinance faces in Latin America is by no means meant to paint a discouraging picture of the industry's future in the region. Indeed, commercial microfinance is on the verge of a vast expansion in Latin America. Within five years, we estimate it will be recognized as a credible asset class and as a socially responsible investment that rivals SRI mutual funds in both risk-return performance and social return.

Nonetheless, there are some risks to this fast-growing development, and those risks will need to be addressed if microfinance expects to gain credibility and access to real institutional capital – which is needed before it can be a recognized asset class.

"A little bit of equity and a lot of technical assistance. That's what will develop the pipeline," says ACCION's Jacobowitz.

Test cases such as Compartamos in Mexico and MiBanco in Peru will establish the groundwork for future microfinance ventures in the region. Their success – or failure – could have a huge impact on what's to come.

About the MicroCapital Institute

The MicroCapital Institute is a non-profit organization supported entirely through private donations. Our mission is to educate financial professionals on the emerging asset class of microfinance.

The MicroCapital Institute
230 Park Avenue, Suite 1000
New York, New York 10169
Tel/Fax: 877.669.5904
Email: **info@microcapital.org**

Copyright © 2004 MicroCapital Institute. All rights reserved.