After a period of rapid growth, microfinance is facing its toughest years yet. But as the region’s biggest banks step up their involvement, the industry has become an ever more integral part of Latin America’s financial mainstream. By Lucy Conger

**Small money becomes big business**

Don’t let the term ‘microfinance’ fool you. After a strong injection of socially-minded capital, this industry has boomed in Latin America. It is highly profitable and rapidly becoming part of the mainstream financial landscape.

Microfinance – lending tailored to low-income owner-operators of micro and small businesses and farms – faces a vast potential market. Indeed, the long-term future of Latin America’s economies and, by extension, capital markets will depend to a large degree on whether microfinance institutions can continue to help millions get out of poverty.

But microfinance in Latin America faces some hard years ahead – largely because of its rapid growth previously. A 2014 survey of 58 of the large microfinance institutions by the Inter-American Development Bank (IDB) and Microfinance Information Exchange (MIX) showed loan portfolio almost tripled between 2008 and 2013, to reach $18 billion.

For most of the post-crisis years, even the region’s biggest microfinance firms – like Mexico’s Compartamos, or Mibanco and Edyficar in Peru – grew lending by 20%, 30%, or more each year, and have generally posted return on equity of as much as 30% or higher.

The sector has seen such strong expansion and profitability that the region’s biggest financial institutions are increasingly paying attention. This year, Credicorp – the financial conglomerate that owns Banco de Crédito del Perú (BCP), Peru’s biggest bank – paid $179 million to acquire a majority stake in Mibanco, Peru’s largest microlender.

“We want to be the leading promoters of financial inclusion in the country,” says Percy Urteaga, general manager of Mibanco and vice-president of the board of Edyficar, the microfinance lender Credicorp bought in 2009. The merger of the two firms will allow the consolidated bank to offer more services, including savings, he says.

Microfinance institutions that have the regulation necessary to take deposits, including those that are regulated as banks, make up around three-quarters of microlending. Now direct control of microfinance by commercial banks is moving the industry “from being a marginal business to being an important part of financial systems”, says Larisa Arteaga, an analyst with Fitch in the Dominican Republic.

Interest by commercial banks in acquiring microfinance companies has risen, particularly over the last two years, says Esteban Altschul, chief operating officer of Accion International, a microfinance advisor and investor. “There are commercial banks that are truly client-focused and they see [microfinance] as a
long-term success,” he says.

Scotiabank already has microfinance operations across Latin America. It bought Crédito Familiar in Mexico two years ago and Banco del Trabajo, a Peruvian consumer and microcredit firm, in 2009. A BBVA-endowed foundation owns eight microfinance units with 1.3 million clients, across six countries in Latin America.

Meanwhile, comments from Banorte’s chief executive, Alejandro Valenzuela, suggest Mexico’s biggest locally-owned bank may soon join the movement. When asked where he sees opportunities for growth, microfinance – and Mexico’s large informal sector generally – is one of the areas to which he points.

Valenzuela says Compartamos has “a fascinating model” and he has “a lot of admiration” for the company.

“We have to find ways for these institutions to work together,” he says. Taking a stake in Compartamos is not “as of yet” on Banorte’s agenda, but the chief executive talks of “building bridges” with microfinance institutions like it.

“Microcredit is like a fashion, and all banks need it,” adds Fernando Albano, a financial institutions analyst covering South America with Moody’s.

International financiers armed with specialist technology and payments systems, like credit card companies, have their sights set on moving into microfinance too, says Sergio Navajas, a specialist in the area at the IDB’s Multilateral Investment Fund (MIF).

LEONOR MELO DE VELASCO, FUNDACIÓN MUNDO MUJER

“The negotiating power of micro-entrepreneurs has increased, because the supply of credit is greater”

Getting bigger
As microfinance lenders and borrowers have proliferated, the average size of loans is going up, too. The change is particularly marked since the 2008 financial crisis. Among the 58 institutions surveyed by the IDB and MIX, the average credit has risen from around $1,550 to around $2,000 in the past five years.

Compartamos, which with 2.6 million clients is Latin America’s biggest microfinance institution, demonstrates the trend. Its credit portfolio has grown much faster than client numbers since 2008, and especially over the past two years.

Patricio Diez de Bonilla, chief financial officer at Compartamos’ parent firm, Gentera, says the firm has had to adapt to an increasingly competitive market over the past five to 10 years. Diez de Bonilla says “people are developing needs” in areas like home improvement, consumption, and savings.

“Our business has evolved over the last 36 months,” he says. “We’re not just focused on microfinance, but also financial inclusion. We’re now a group of companies, with a more diversified credit portfolio, as well as savings, insurance and correspondent banking.”

After an increase in bad debt, Compartamos has cut its non-performing loans to 2.2% of the credit book by June 2014, from 4.1% a year earlier: one sign of a more cautious approach in the industry. But worries that Latin America’s microfinance borrowers are taking on unsustainable amounts of debt linger, in part because of higher loan sizes.

A July 2014 global study funded by Accion and Citi noted rising anxiety about over-indebtedness in the sector. Two thirds of the 306 microfinance institutions and observers surveyed ranked over-indebtedness as the greatest risk facing the sector, far ahead of worries such as funding, liquidity, or political interference.

Although this was a global study, the dangers of over-indebtedness were seen to be more severe in Latin America than any other region, and above all in Peru – the world’s largest microfinance market, with around $10 billion in loans. In Peru, respondents gave their concern over credit risk a score of 9.5 out of 10, compared to a global microfinance average of 6.9.

The results were particularly striking as in previous surveys the Peruvian environment for microfinance had ranked highly, according to the report.

That was in part because of the sound reputation of the local regulator, the SBS, which monitors the origination practices for lending to microenterprises, consumers and home-buyers.

“When we see a strong appetite for risk and that the entity is not using robust risk management, we apply a penalty for over-indebtedness that requires additional provisioning for the portfolio,” says Rubén Mendiola, deputy supervisor for banking and microfinance at the SBS.

The capitalization levels of microfinance companies in Peru are high – at least 14% – in compliance with SBS requirements and the phasing in of Basel II and III standards, Mendiola adds.

Over-indebtedness has not, perhaps, historically been part of the Latin American microfinance tradition. Low-income debtors have tended to repay their obligations to preserve their access to borrowing, and build up a record that will qualify them for successively larger credits. However, microfinance – especially in Peru – has in recent years been a victim of its own success.

“There is more competition because banks have seen microcredit as a niche; they see that poor people pay back,” says Leonor Melo de Velasco, executive director of Fundación Mundo Mujer (FMM), one of Colombia’s oldest microfinance institutions. “Negotiating power of micro-entrepreneurs has increased, because the supply of credit is greater.”

Investment push
One cause of the growth in competition is an abundance of capital from so-called impact funds, usually based in Europe and the US, and which look to promote a social gain but also earn a yield. Much of the money has been deployed through microfinance investment vehicles: funds adapted to the needs of microfinance, but run by managers experienced in more traditional investing.

A scarcity of institutions that can use those funds has concentrated the capital in a small number of countries, according to the Accion-Citi study. One study conducted by MicroRate, a specialist ratings agency based in Peru, showed assets of microfinance investment vehicles more than doubled each year in the run-up the global financial crisis, and then doubled again over the next four years, reaching around $8 billion by 2012.

Partly as a result, hundreds of new lenders have piled into the sector, looking to gain market share in countries like Peru – especially in urban centers. Often they arrive with what Altschul at Accion describes as “aggressive” sales campaigns.

“In Peru, where competition is fierce, they cannot afford to pick clients, so they have to lower standards,” says Damian van Stauffenberg, MicroRate’s founder and president.

In this environment, across Latin America, microlenders are increasingly offering clients bigger loans, and doing so without
properly evaluating the risks, says Melo at FMM. Some clients are even borrowing from one institution to pay off debt at another in Peru, according to van Stauffenberg.

High growth rates in lending have strained control systems, while concealing growing risks, says María Belén Effio, general manager of MicroRate for Latin America and the Caribbean. “If you lend more, you dilute the portfolio at risk. You have a low indicator of non-performance — but it is not low because of repayments.”

Historically, the ratio of loans in arrears for more than 30 days in Latin America has ranged between 0.5% and 2%, according to Fernando Prado, general manager of Prospero, a microfinance equity investment fund. “Anything above that means something is not working,” he says.

But in Colombia and Peru, microfinance loans in arrears of more than 30 days are now around 6% of the portfolio. Moreover, and despite signs that bad debt levels in some countries have begun to subside, an economic downturn in these countries could cause the level of arrears to double, says Altschul at Accion: a particular risk for Colombia and Peru, after a further decline in commodities prices in October.

By contrast in Bolivia, where microfinance accounts for half of credit in the financial system, loans in arrears make up just 1.5% of the portfolio. The low debt and high proportion of microfinance in Bolivia “shows the possibility of microfinance to become a large component of the financial system,” says Claudio González Vega, Ohio State University professor emeritus of rural finance.

**Slowdown**

Replicating the Bolivian example elsewhere in the region could now be much harder, given over-indebtedness, and bad debt levels in microfinance — or at least worries about this.

Overdue loans in some countries have continued to increase over the past two years. In Colombia, for example, microfinance loans overdue for more than 30 days increased by 50% over the past two years, to 6.3% of the portfolio, according to the country’s National Guarantee Fund.

However, in the 58 institutions surveyed by the IDB and MIX, loans more than 30 days in arrears actually dropped to 4% in 2013, having risen from 3.6% to 5% between 2008 and 2011. Overdue bad debt remains higher than average in Peru, at around 6%, although there too it has declined over the past two years, from a high of around 8% two years ago, according to MIX.

**Good capital**

*Microfinance investment vehicles’ assets, 2005-12*

<table>
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<th>Year</th>
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<th>Microfinance portfolio ($ bn)</th>
<th>Survey participants</th>
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Source: MicroRate MIV Survey 2013

Yet as the Accion-Citi survey shows, worries about over-indebtedness in the industry are still high. Those concerns may be less likely to subside, following the further declines in commodity prices and the generally disappointing macro-economic data in Latin America in recent months.

Moreover, worry about over-indebtedness appears to be impacting the growth of microfinance. The increase in the number of microfinance clients in the 58 institutions in the IDB-MIX survey slowed to just 1% in 2013, while average loan growth among the 58 institutions was 7%. Partly due to a focus on bringing down bad debt, loan growth at Compartamos, for example, slowed to just 5.37% in the year to June 2014.

Does the slowdown signal an end to the boom? Was microfinance, perhaps, always just a fad — and a particularly risky one?

Perhaps not. Indeed, the interest in microfinance among institutions like Banorte and Credicorp suggests the ascent of microfinance may be only just beginning. In some ways, the concern about over-indebtedness is leading to a situation where microfinance is ever more integral to the mainstream banking system in Latin America.

It is not just that microfinance institutions are gaining the regulatory approvals needed to convert into banks, although that is happening (Banco WWB, one of Colombia’s biggest microfinance institutions, became a bank in 2011, for example). A newer trend is that some of the thousand-plus independent microfinance institutions across the region are consolidating, and partly because of continued worries about over-indebtedness.

Credicorp’s acquisition of Mibanco — and its merger into Edyficar — is an example.

Last year, after an ambitious regional expansion in microfinance, Mibanco’s majority shareholder Grupo ACP breached debt covenants on its $85 million 2021 corporate bond. Regional foreign exchange volatility led to losses at ACP, according to Fitch. Return on assets at Mibanco, ACP’s biggest revenue generator, dropped to 0.74% in the first half of 2014, mainly due to credit losses.

The Accion-Citi report describes the merger with Edyficar as “a symptom of the sector’s malaise”: Mibanco was sold for just 1.3 times book value, compared to a book value of 2.5 times that Credicorp paid for Edyficar in 2009.

Now difficulties at the smaller regional savings and loan associations in Peru may spur further consolidation, says Prospero’s Prado. “Mergers are the name of the game in Peru,” he says.

Eduardo Torres Llosa, chief executive at BBVA Continental in Peru likewise mentions loan-loss ratios at rural loan and savings associations and their urban equivalents as a factor likely to lead to M&A. “They need to gain scale,” he says. “Microfinance is going through a consolidation process normal to any sector.”

News broke of another acquisition in Peru in April. Diviso Financial Group, owner of Cusco-based Credinka, bought a 67% stake in Arequipa microfinance lender Financiera Nueva Visión, for
ad
Capital markets

Managing mismatches

Up to now, microfinance firms have offered few opportunities for investors in the international capital markets. Bankers say this is beginning to change, particularly as the sector becomes more consolidated.

Until a few years ago, microfinance firms could only aspire to borrow from social impact funds. Liquidity in local markets has already increased the options, says Santiago Arias, portfolio manager at Pinebridge Investments.

Compartamos Banco, for example, taps Mexico’s local debt market regularly: its 2 billion peso ($155 million) five-year floating rate bond in June was 3.4 times over-subscribed.

“There is strong interest from local investors,” says Arias. “This sector has shown that it is sustainable. Before only non-governmental organizations would look at it, and now local investors are keeping a close eye.”

Juan Claudio Fullaondo, head of investment banking financing for Mexico at HSBC, says microlenders are making progress attaining the ratings and regulatory requirements needed to tap international markets.

He points to a $200 million five-year non-call three bond, priced at a yield of 7.75% in May, for Financiera Independencia in Mexico. The deal was five times over-subscribed. The deal was a securitization, says Fullaondo, partly due to the borrower’s sub-investment grade rating.

“What Findep did is going to pave the way for many issuers,” says Fullaondo. “These companies lend in local currency, so they have to cover their FX risk, and convert the money they borrow into local currency, so it could be a little expensive if you don’t know where to tap or at what levels.”

Impact funds have had to find ways to cover their foreign exchange exposure, too. US based MFX Solutions has hedged $650 million in microfinance loans, covering more than 40 currencies, after gaining a $20 million credit guarantee from the US government’s Overseas Private Investment Corporation (OPIC) in 2009.

“Currency risk is sometimes called the original sin of microfinance,” quips Brian Cox, MFX’s president. It can be difficult for microfinance firms to find collateral to buy swaps from big international banks, he says, and finding facilities for smaller markets like Bolivia or Nicaragua is especially hard.

MFX started hedging in early 2010, when microfinance institutions still had fresh memories of the sharp drops in emerging market currencies following the 2008 financial crisis.

“That shocked, it had a demonstrative effect,” says Cox.

Global Partnerships, a non-profit investor based in Seattle, is a founding member of MFX. “We’ve seen institutions lose money when currency markets become volatile,” says Mark Coffey, chief investment and operating officer.

“Regulators are pushing microfinance institutions to make their asset-liability mix more balanced.” LF

27 million soles ($9.6 million), part of a drive to expand in the less penetrated rural areas.

“The medium- and small-sized micro-lenders should start looking for synergies and tie-ups,” says Fernando Romero, Divisó’s chief executive. “Before there is a wave of international investments in the sector, there needs to be a wave of consolidation.”

Juan Claudio Fullaondo, head of investment banking financing for Mexico at HSBC, sees a similar trend towards mergers in his country. “There are plenty of microfinance lenders in Mexico, and you will see a process of consolidation,” he says.

Government support

Perú’s SBS seems to be, at the very least, permissive of consolidation in microfinance. “The superintendence has been very neutral regarding mergers,” says Mendiola. “Many [institutions] are aware that it is a business of scale [and that] it is difficult to compete.”

And another factor in favor of microfinance’s continued journey towards the mainstream is the increasing support of governments. Microfinance is gaining attention from politicians keen to promote “financial inclusion” – the buzz word for financial services that are accessible to the working poor.

Colombia’s president in October signed a bill that allows the creation of mobile phone-based financial companies specialized in electronic deposits, transfers and payments. Accounts can be opened with just a national identity card, and the companies can be capitalized with one tenth the capital required to open a bank. Clients will build up a history of savings and payments that can help them gain access to loans in the future, finance minister Mauricio Cárdenas said.

The objective of bringing more people into the banking system is also a major part of why mainstream commercial banks remain interested in microfinance. Since 2012, Edyficar and Mibanco alone have made financial services accessible to 400,000 first-time clients, but more than half of Latin Americans still have no access to formal financial services (and only 10% of Peru’s rural population has a bank account, according to Divisó’s Romero).

At Colombia’s Bancamía, one of the largest institutions in the BBVA foundation, 32% of clients have moved out of poverty (defined as an income of lower than $4 per day) in the past year alone, says María Mercedes Gómez, the bank’s executive president. On average around 11% of clients’ businesses will become small businesses, she says.

Credits at Bancamía “aim to generate income in the base of the economic pyramid”, says Gómez. Lending is tailored to fit each client’s business plan and payment capacity, to help improve the value of their micro-enterprises, and to strengthen profit generation and accumulation of assets, she says.

Claudio González-Vega, a board member at BBVA’s microfinance foundation, says the organization “is an act of social responsibility” that is “de-linked” from the main bank. Torres likewise says there are no commercial synergies between the main bank and BBVA Foundation’s Peruvian units.

But in a decade or two, the benefits of the foundation’s work could rub off on the for-profit bank, and the clients’ credit profiles could be shared, says Torres. “I do not discard that in the future we could work with common clients,” he says.

“We are interested in developing new financial clients; that’s the idea of the microfinance institution, to help families get out of...
poverty. In the long run, we will have more clients,” he says. “If the microfinance company keeps focusing on very low income clients and small ticket loans, when that client reaches a certain point, we will be able to get that client.”

**Synergies – and differences**

Closer tie-ups between commercial banks and microfinance units can give the latter access to cheaper funding. The banks, in turn, can benefit from microfinance’s in-situ client visits, hands-on cash flow analysis, and loans that fit the repayment capacity of each borrower. Both can share each other’s physical distribution infrastructure.

Due to similar synergies, the relationship with BCP helped Edyficar grow its portfolio four times in five years, says Urteaga. Edyficar’s reach expanded through access to BCP’s network of 5,000 banking agents in post office, stores and local businesses, he says.

Banorte’s Valenzuela similarly says that commercial banks and microfinance firms should do more to share infrastructure and relationships. Bringing down funding costs for microfinance institutions would lower clients’ borrowing rates, he says: “These ideas will have to be worked through.”

But Valenzuela acknowledges that microfinance necessitates “a particular way” as compared to other areas of banking: “We’re not that good in that market segment.”

Van Stauffenberg at MicroRate says: “In the best cases, this is a marvelous combination giving microfinance access to unlimited funding and a commercial bank access to the microfinance market.” But in successful marriages between large commercial banks and microfinance outfits, the banks “buy them, control them and let them operate in their own style,” says van Stauffenberg.

**SERGIO NAVAJAS,** **INTER-AMERICAN DEVELOPMENT BANK**

“My fear is that for very large banks, these markets represent a very small portion of revenues. If tomorrow there is a shock and they get out, the risk is they abandon clients.”

“Edyficar would not have been able to grow if it were integrated into BCP – within the bank, you compete for resources with very large units,” agrees Urteaga.

That is not to say there are no other risks of such combinations, however. “My fear is that for very large banks, these markets still represent a very small portion of their revenues. If tomorrow there is a shock and they get out, the risk is they abandon clients,” says Navajas at the IDB.

And if commercial banks – eager for bigger clients – encourage newly acquired microfinance units to load clients with too much debt too soon, it could be counter-productive, as recent developments in the sector have demonstrated.

“We all lose with an over-indebted client,” says Melo of FMM. “We have to take more care in granting loans.” LF

*Additional reporting by Eduardo García and Dominic O’Neill*