Guide

ELLA Area: Economic Development

ELLA Theme: Microfinance

ELLA
Evidence and lessons from Latin America

Unique features of Latin America's recent microfinance evolution - including innovations in regulations and technology - reflect lessons learned that may be interesting for other regions.

GUIDE TO MICROFINANCE IN LATIN AMERICA

SUMMARY

Developing countries around the world struggle with supplying resources to the poor. Though social assistance programmes are one option, the challenge of creating dependence amongst the intended beneficiaries always arises. Hence the draw of microfinance, an institution with origins in Europe in the 1800s as a 'cooperative movement' involving urban wage earners and small farmers, that has been adopted in Latin America and has grown at a two-digit rate for the past decade. This Guide reviews the concept of microfinance as developed in Latin America, underscoring its unique features. We present an overview of its recent evolution and the current state of the market. The different types of institutions offering microcredit in the region are also presented and analysed. Next, regulations and practices of Latin American institutions are presented, as they are key to understanding microcredit in a context where neither guarantees nor documentation is mandatory. Finally, the Guide reviews technologies and strategies that microfinance institutions use to increase profits and presents what may be the next frontier for the industry, integrating services to support company development combined with microfinance. The Guide concludes with lessons that may be relevant for other contexts, as well as highlighting key publications and organisations related to microfinance in the region.

MICROFINANCE IN LATIN AMERICA: AN INTRODUCTION

Microfinance is often defined differently according to the model, target group and services offered. Despite this diversity, generally microfinance is understood as an industry orientated to providing small-scale financial services without the collateral of traditional banking. This definition acknowledges variations across the world, though there are traditional features related to microfinance, such as small transactions and minimum balances either through loans, savings, or insurance; loans for entrepreneurial activity; simple application processes; market-level interest rates; and collateral-free loans. In addition, other features include group lending, targeting poor clients or women, and providing services to underserved communities that may or may not be implemented by a microfinance institution (MFI).[1]

[1] Karlan, D., Goldberg, N. 2007. *Impact Evaluation of Microfinance: Review of Methodological Issues*. World Bank, Washington, DC.

The Latin American model is different from African or Asian models in that MFIs tend to operate more as private businesses, thus being subjected to everything that is asked from a business in terms of profitability and sustainability. The model is also different because it emerged through private non-profit institutions working in urban markets. The original focus of the microfinance business has been the unmet demand for credit in the informal sector, thus the target market has been enterprises without access to financial services. For this reason, microfinance in Latin America may be defined as financial services provided in particular to microenterprises, including owners, operators and workers. That being said, obviously there is variation between Latin American countries, depending on circumstances related to the development of the financial market, the regulatory framework, macroeconomic stability, available human capital and technological adoption.[2]

The following section provides a brief overview of Latin American microfinance, focusing on key performance indicators, the structure and type of Latin American MFIs and the existing evidence on MFI impact.

Performance of the Latin American Microfinance Sector

Figure 1 shows some key performance indicators across 48 Latin American MFIs for 2011. MFIs have grown strongly in the past five years, in spite of the international financial crisis. This growth continued in 2011, with an increase of over 20% in the indicators of scale and outreach. In particular, the gross loan portfolio grew 24%, leading to an increase in assets of 19%.

In terms of the competitiveness of the Latin American microfinance business environment, although empirical evidence is not abundant on the subject, using the Global Microscope Rating, Olsen (2010) tested the effect of regulation on number of borrowers using firm-level data of MFIs in Latin America and found it has a positive and significant effect on ability to attract borrowers.[3] In addition, the Global Microscope Rating is also proof itself of the positive trend of the business environment of Latin American microfinance acknowledged worldwide.[4] Nowadays, eight of the top

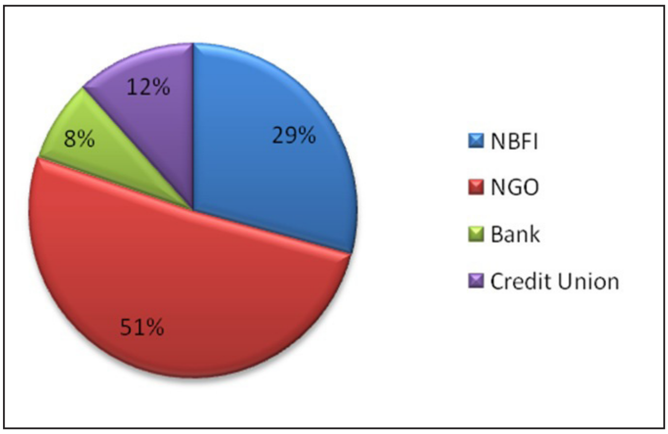
Figure 1: MFIs Main Accounts and Indicators for 48 Latin American MFIs, US$ Millions (2011)

Main Accounts and Indicators of 48 Latin American MFIs	2011 Balances	% Growth '11/'06[1]	% growth '11/'10
Borrowers ('000)	10,512	17%	17%
Depositors ('000)	14,096	24%	9%
Gross Loan Portfolio	15,797	23%	24%
Microenterprise[2]	8,707	n/d	23%
Other credit types	7,089	n/d	24%
Assets	20,718	23%	19%
Deposits	12,629	25%	20%
Borrowings	3,765	19%	23%
Equity	3,264	24%	18%

[1] Annual average
[2] Final MFI information for Bolivia, Ecuador and Peru, and estimated for the other countries

Source: Martínez, R. 2011. *Latin America and the Caribbean Microfinance Trends 2006-2001*. The MIX Market, Washington, DC.

Figure 2: Charter type - Latin America and the Caribbean (2008)



Own elaboration. Source: The Mix Market, Trendlines 2006-2008 MFI Benchmark Tables.

[2] Berger, M. 2006. *An Inside View on Latin American Microfinance, Chapter 1: The Latin American Model of Microfinance*. Inter-American Development Bank (IDB), Washington, DC.
[3] Olsen, T. 2010. *New Actors in Microfinance Lending: The Role of Regulation and Competition in Latin America*. Koninklijke Brill NV, Leiden.
[4] This report is commissioned by the Multilateral Investment Fund of the Inter-American Development Bank (IDB), the Andean Finance Corporation (CAF), and the International Finance Corporation (IFC), and is elaborated by the Economist Intelligence Unit.

dozen countries that rank in the report are in Latin America, with Peru and Bolivia raking first and second, respectively.

The Structure of the Sector: Organisation Type

The MIX market (Microfinance Information Exchange) classifies Latin American MFIs into four types based on their legal status: banks; credit unions; non-governmental organisations (NGOs); and non-banking financial institutions (NBFIs). Figure 2 shows the composition of the market in 2008 by number of institutions according to these four types. Clearly, NGOs represent a large share of the sector (51%), followed by NBFIs (29%) and credit unions (12%). Though commercial banks appear to have the smallest share (8%), the weighted average of active borrowers by 2011 is evidently almost as high as in NBFIs, reaching approximately 7 million, as seen in Figure 3.

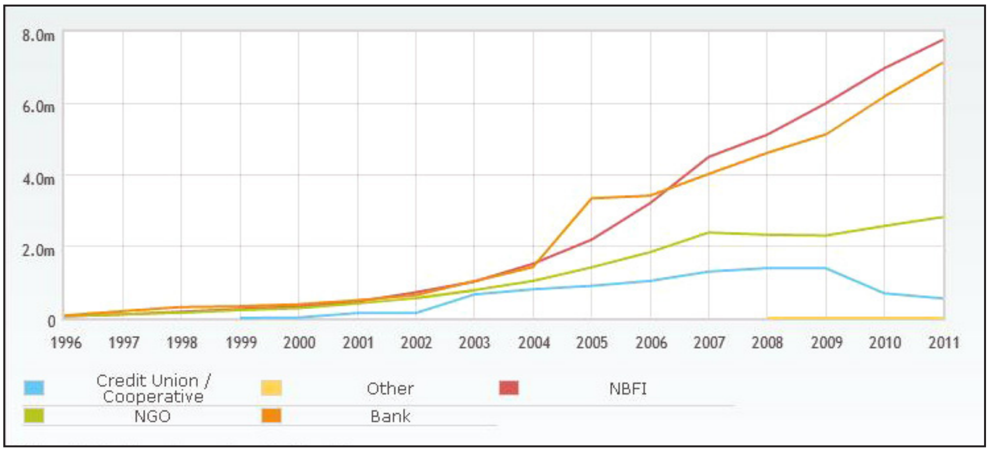
In terms of the number of active borrowers, Figure 3 shows that NBFIs lead the market. However, the gross loan portfolio of commercial banks exceeded the combined NGOs' and credit unions' portfolios by 10.5 billion on average (the number was 13 billion approximately). Also, the NBFI's portfolio was on average around US$ 11 billion.[5] Deposits are not comparable, however, since only regulated MFIs can offer them, while NGOs and some NBFIs cannot. For this reason, we emphasise the role of the regulated microfinance sector in the ELLA knowledge materials on microfinance.

Within the framework set out above, it is interesting to note the many different types of NBFIs that operate in Latin America. The advantage of NBFIs is that they are regulated institutions providing microcredit that are often offered special tax and leverage incentives in order to formalise, as well as access to capital markets. Figure 4 summarises 11 types of NDFIs created to provide microcredit in Latin America, each with different characteristics depending on the regulatory framework of each country.

As Figure 4 shows, most institutions have the legal form of a shareholder company, because it is preferable that only credit unions and shareholder-based institutions operate as deposit-taking intermediaries. Exceptions to this are clearly the case of CMACs in Peru and OPDFs in Honduras. The case of Honduras is questionable, though, since this MFI can remain a non-profit organisation while operating as a financial intermediary. Aside from this, differences across all institutions are mostly related to requirements and permitted operations.[6]

Finally, note that the charter type is different from another classification of MFI types commonly used: Upgrades, Downscales and Greenfields. This latter classification refers to the way the MFI emerged. Greenfields are institutions created to provide microcredit and thus are highly related to NBFIs; upgrades are NGOs who became regulated institutions and are also NBFIs; and downscales

Figure 3: Number of Active Borrowers (Weighted Average)



Own elaboration. Source: http://www.mixmarket.org/profiles-reports/crossmarket-analysis-report. To construct the graph, the following data was used: Number of Active Borrowers, All dates, Filter: Latin America and the Caribbean, Group: Current legal status, Sum.

[5] Raw data found at: http://www.mixmarket.org/profiles-reports/crossmarket-analysis-report.
[6] Rosales, R., Janson, T., Westley, G. 2004. *Principles and Practices for Regulating and Supervising Microfinance*. Inter-American Development Bank (IDB), Washington, DC.

Figure 4: Financial Institutions Created to Provide Microcredit

Year	Country	Name	Legal Form	Owners
1980	Peru	*Caja Municipal de Ahorro y Crédito* - CMAC	Municipal enterprise	Municipal governments
1992	Peru	*Caja Rural de Ahorro y Crédito* - CRAC	Shareholder company	Individuals and institutions
1994	Peru	*Entidad de Desarrollo a la Pequeña y Microempresa* - EDPYME	Shareholder company	Individuals and institutions
1995	Bolivia	*Fondo Financiero Privado* - FFP	Shareholder company	Individuals and institutions
2000	Brazil	*Sociedad de Crédito para el Microempresario* - SCM	Shareholder company	Individuals and Institutions
2000	El Salvador	*Sociedad de Ahorro y Crédito* - SAC	Shareholder company	Individuals and institutions
2001	Venezuela	*Banco de Desarrollo Especializado en Microcrédito* - BEM	Shareholder company	Individuals and institutions
2001	Honduras	*Organización Privada de Desarrollo Financiero* - OPDF	Private nonprofit entity	There are no owners, only founders
2001	Mexico	*Sociedad Financiera Popular* - SOFIPO	Shareholder company	Individuals and institutions
2001	Mexico	*Sociedad Cooperativa de Ahorro y Préstamo* - SOCAP	Cooperative	Individuals and institutions
2001	Panama	*Banco de Microfinanzas* - BMF	Shareholder company	All those who can be shareholders of bank

Source: Rosales, R., Janson, T., Westley, G. 2004. *Principles and Practices for Regulating and Supervising Microfinance*. Inter-American Development Bank (IDB), Washington, DC.

are banks that expanded their original services to provide microcredit and other microfinance products and services.

Impacts of Latin American Microfinance: What is the Evidence?

A recent systematic review of microfinance studies concludes that "almost all impact evaluations of microfinance suffer from weak methodologies and inadequate data".[7] This conclusion underlines the methodological and practical difficulties of implementing rigorous evaluations. Though evidence of microfinance's effectiveness is limited, as the authors acknowledge, clearly there is a demand for credit and other financial services, a demand that a dynamic and flexible microfinance industry adapted to local rural realities may be able to meet.

There is some Latin America evidence that microfinance is having a positive impact on such variables as firm revenue, employment and fixed assets.[8] Also, McIntosh et al. (2008) examined data from 1,672 rural households accessing microfinance in Guatemala, India and Ghana.[9] Using econometric models, they find that after credit provision in the village, the probability of investing in housing improvements and making business investments increases two and three-fold, respectively.

There is also evidence that microcredit may have a positive

[7] Duvendack, M. *et al.* 2011. *What is the Evidence of the Impact of Microfinance on the Well-being of Poor People?* EPPI-Centre, London.
[8] Gutierrez, C., Soares, F. 2011. *What is the Evidence on Microfinance Impact? A Review of Microfinance Impact Evaluations in Latin America and the Caribbean*. Working Paper Series. Multilateral Investment Fund (FOMIN), Washintong, DC. The study analyses published evidence of impact evaluations of microcredit, microcredit plus additional services, and impacts related to savings and new technologies in Latin America, covering 20 impact assessment studies over the past 13 years.
[9] McIntosh, C., Villaran, G., Wydick, B. 2008. *Microfinance and Home Improvement: Using Retrospective Panel Data to Measure Program Effects on Fundamental Events*. University of California, San Diego.

impact on children's education. In effect, all studies explored in a recent survey of microfinance impacts in Latin America find positive and significant impacts of microcredit on education. For example, Maldonado and Gonzalez-Vega (2008) compared clients who have been engaged in microfinance for some time to new clients in rural Bolivia and found that children of these longer-term clients have about a quarter to a half of a year less of a schooling gap than children from new client households.[10]

INSTITUTIONAL ENVIRONMENT

As in Asia and Africa, the adoption of microfinance in Latin America was neither fast nor easy: before the late 1980s, the poor regulatory system discouraged both private investment and consumer confidence. The sector was dominated by NGOs dependent on donor money, with low coverage, poor management standards and low sustainability; recovering principal and, consequently, sustainability was not a concern. It was not until the financial reforms of the late 1980s and 1990s that financial intermediation and allocation of credit improved, promoting healthy competition and boosting the sector's rapid development.[11] Important factors that, though negative, enabled these reforms included scepticism about the ability of the state to provide goods and services, inadequate and often out-dated regulatory systems and a weak financial sector. This section of the Guide focuses on the institutional environment for microfinance in Latin America, in particular discussing the key financial sector and microfinance-specific reforms implemented.

In the late 1980s and 1990s, many countries implemented sector-wide financial reforms including liberalisation of interest and deposit rates, elimination of targeted credits, reduction of legal reserves, appearance of universal banking and modernisation of capital markets regulation. Although most reforms were pushed through to deal with general financial challenges, some countries took advantage of the context of reform to implement policies that specifically supported microfinance's sustainability. Liberalisation of interest rates, for example, was fundamental to generate sustainability in a context of lending with no real guarantees. Also, almost all Latin American countries liberalised deposit rates, while only a few countries kept lending rates under the control of either the central bank or the financial regulating agency. Elimination of targeted credits, meaning assigning a percentage of total credit to a certain sector, was also uniform across the region, except for in two small countries, Jamaica and Paraguay. Although widespread, the reduction of legal reserves varied significantly from country to country, and universal banking allowed financial institutions to engage in different operations.

Microfinance-specific Regulations

In Latin America, different types of regulations cover the microfinance sector. Some countries, such as Colombia, Ecuador and Nicaragua, opted for a specific regulation for MFIs, whereas most countries, like Peru, decided to include microfinance within traditional banking regulation. The question as to which of these two approaches is the best to regulate microfinance has yet to be addressed by the literature. Latin American experience seems to indicate that there is not necessarily a best way, but that the important issue is to tailor regulations to each country's circumstances. On the one hand, including microfinance within traditional banking regulation makes oversight easier, as the same set of rules apples to the whole financial sector. Both of the Latin American countries considered to be the most advanced in terms of microfinance, Peru and Bolivia, use this approach. On the other hand, having specific regulations might help microfinance to develop faster in the initial stages, with fewer requirements than in traditional banking. Eventually, however, just as an infant industry needs

Figure 5: Principles and Practices in Regulation of Microfinance in Latin America

Practices and principles used to regulate...	
Microenterprise Lending	MFIs Specialising in Microcredit (Best Practices)
Internal lending process Not predefined collateral or documentation Freedom to set interest rates Contractual transparency Non-performing loans policies Risk classification of loans Legal recovery Risk weighting Rescheduling or restructuring loans Loan loss provision Loan write-offs	Sound minimum capital requirement Strict standards for related-party lending Graduation system for permitted operations Operations at the national or regional level

Own elaboration. Authors view on the subject and adaptated from: Rosales, R., Janson, T., Westley, G. 2004. *Principles and Practices for Regulating and Supervising Microfinance*. Inter-American Development Bank (IDB), Washington, DC.

[10] Maldonado, J., González-Vega, C. 2008. *Impact of Microfinance on Schooling: Evidence from Poor Rural Households in Bolivia*. World Development 36(11) 2440-2455.
[11] Rennhack, R. 2009. *Global Financial Regulatory Reform: Implications for Latin America and the Caribbean (LAC)*. International Monetary Fund (IMF), Washington, DC.

to eventually catch up with the standards for the sector, it seems to make sense to ultimately streamline microfinance with the rest of the financial system.

In general, as Figure 5 shows, regulation of microenterprise lending in Latin America aims to account for the fact that microfinance is different from traditional lending operations. For instance, the focus is on a proper lending process, but regulations do not pre-define levels of collateral or the documentation needed to approve a loan. However, institutions must have written manuals and institutional policies, interest rates should be freely set but cannot be modified unilaterally and clients should always be kept informed. Other regulations focus on risk management: non-performing loans should be recorded as past due, loans should be classified and weighted by risk, loan loss provisions are mandatory, and a well-defined capital adequacy ratio is needed, typically capital to risk-weighted assets between 10% to 15%. In addition, operations are not restricted by geographical area or sector in order to diversify risks, but established limits on loan size and loan write-off standards with legal recoveries should be periodically assessed.

Other regulatory practices from Latin America focus on institutional features of microfinance providers. These include: adequate definition of the legal form and purpose of created institutions; participation of investors to encourage discipline; the same standards for shareholders to create MFIs as in traditional banking; predefined responsibilities for the board of directors in the regulatory framework; established permitted operations according to the legal form; and limits on the role of indebtedness in funding.

Among the best practices listed in the second column of Figure 5 are minimum capital requirements of about US$1 million and prohibition of or tight restrictions on related-party lending. Also, regulations allow and motivate operations at the national or at least regional level in order to achieve efficiency and offer competitive rates to clients. Among the most interesting practices is a graduation system that allows MFIs to access more complex or risky operations and offer a broader range of services subject to fulfilling specific requirements. For instance, the Peruvian regulatory framework enables different operations according to the legal form. For example, while savings and credit rural institutions (CRAC) and municipal savings banks (CMAC) are allowed to accept deposits, EDPYMES are not. All can have credit lines from domestic and external sources; and while all can offer commercial and consumer loans and loans to microenterprises, only CMACs can pawn.[12]

Finally, one important set of institutional reforms orientated to improving risk management in Latin America, in addition to strengthening the role of the supervising entity, is related to the creation or promotion of supporting institutions, such as credit rating agencies and credit bureaus. Peru's 1996 law states that the activities of private credit bureaus (CEPIRS) must be regulated and that anyone can access public credit bureau information by paying a fee. A good example of the particular features of such supporting institutions in Latin America is Ecuador's *Red Financiera Rural* (Rural Finance Network - RFR), an association of small financial intermediaries that promotes microfinance market development and provides technical assistance to members in rural areas. Starting very small, it encouraged MFIs to enhance coverage through credit bureaus by offering legal and software training and delivering free report services about shared clients. As a result, though starting with only two MFIs in 2005, by 2007, 113 MFIs were sharing information on 159,000 clients.

More regulatory best practices with examples from additional countries can be found in the ELLA Brief: Latin America's Institutional and Regulatory Innovations for Microfinance Growth.

Success Stories in Regulation: Spotlight on Peru's *Cajas Municipales*

One of the more successful and influential initiatives in Peru's microfinance story is the system of *Cajas Municipales*, or 'cash shops'. Of the many independent *Cajas* that grew to be successful, *Caja Trujillo* is an illustrative case, in which business experimentation and the development of regulation by sector authorities met harmoniously to produce a successful story of sound microfinance growth. *Caja Trujillo* was created when the city government joined in the nation-

[12] Porras, G. 2007. *El Sistema de EDPYMES en el Perú: Necesidad de Ajustes Normativos hacia la Consolidación de la Industria.* (The *EDPYMES* System in Peru: The Need for Legal Adjustments towards the Consolidation of the Industry). International Development Law Organization (IDLO), Rome.

wide initiative to build an institution that would bring credit to people of reduced means and heighten decentralisation of economic development in Peru. With a strong reaching-out-to-the-customer approach as the basis of credit evaluation, a well-adapted technology matched with strong organisational design brought *Caja Trujillo* to a leading position in the Peruvian microfinance industry. This MFI and sister *Cajas* in other regions of the country have grown consistently since the early 1980s, weathering domestic and international economic crises. Risk-management flexibility combined with prudential measures reflect the core of the story. The cash-flow assessment of customer credit and the modular approach to MFIs' operational upgrading were eventually translated into regulation for the whole industry. In-the-field assessment methods, building competent and loyal staff, and strong information technology systems and operational organisation were key contributions to *Caja Trujillo's* good performance and continuing potential for success.

To learn more, read the ELLA Case Study Brief: Peru's Microfinance Sector and the *Caja Municipal* Model.

LENDING TECHNOLOGY

Many regions across the world have lessons to share in innovative microfinance technology. Because MFIs have had to confront the challenge of making it profitable to provide credit in the form of small loans with no formal information, like accounting books, and no real guarantees, technology thus plays a key role in lowering transaction costs to increase profitability. The Latin American region has the most to share when technology is understood in its broadest sense, not only focusing on technological advances in equipment, but in the personnel, processes and procedures that make use of these advances. In particular, Latin American countries have made great advances in on-site monitoring, decentralised decision making and human resources; each of these is explored more fully in the ELLA Brief: Latin American Innovations in Microfinance Technology.

There are a number of indicators of Latin American microfinance making effective use of technology in this broader sense. Figure 6 shows that the mean lending costs per borrower, defined as operating expenses divided by the number of active borrowers, have increased over the years. Rather than portraying a less efficient industry, however, this trend reflects both the growing reach and increasing sophistication of microfinance. In effect, Latin American microfinance goes where the client is, looking for clients instead of waiting for them to come. This means that expanding the client base has increasing costs, as the more isolated client is harder to reach. In addition, product diversification implies greater costs per borrower, but also greater options of services for clients, such as savings accounts and ATMs. This trend contrasts with that of interest rates, which have witnessed a decline over the same period in the most advanced Latin American microfinance markets.[13] It is

Figure 6: Mean Costs Per Borrower (US$)

Own elaboration. Source: http://www.mixmarket.org/profiles-reports/crossmarket-analysis-report
To construct the graph, the following data was used: Cost per borrower, dates after 2000, Filter: Latin America and the Caribbean, Group: Profit Status, Median.

[13] For data on Bolivia, see: Peck, R. 2012. *Microfinance in Latin America*. Multilateral Investment Fund (MIF), Washington, DC.; For more about Peru, see: ELLA Case Study: Peru's Microfinance Sector and the *Caja Municipal* Model.

worth noting that though costs per borrower for for-profit institutions are higher, they have been rising much more slowly than those of non-for-profits, which have more than doubled, possibly due to regulatory and funding costs.

Another key strategy for microfinance growth in Latin America is cultivating long-term client relationships. One key instrument for developing these relationships is scaling-up loans: the relationship starts with the granting of a small loan to a client, and once ability to repay has been tested, loans may be extended or augmented. As the client develops a credit history, the relationship between the institution and borrower becomes a long-term one that allows microfinance staff to predict clients' needs and tailor products to them. Figure 7 illustrates the different types of products Latin American institutions have developed. Consumer credit had - and still has - an important presence in the business, since 90% of commercial banks and 78% of MFIs surveyed reported offering consumer loans. Second in line are commercial loans, followed by mortgage loans.

Figure 7: Product Offerings by Surveyed Institutions in Latin America

	Commercial Banks	MFIs	NGOs
LOANS			
Consumer	90%	78%	38%
Commercial	70%	67%	31%
Mortgage	60%	44%	25%
Microcredit	90%	100%	100%
Rural	50%	33%	44%
SAVINGS			
Accounts	70%	44%	6%
ATMs	60%	44%	6%
Internet	20%		
Remittances - National	50%	22%	
Remittances - International	30%		
OTHER SERVICES			
Insurance	50%	11%	6%
Training		11%	38%

Source: Marilanda, B., Otero, M. 2005 *The Profile of Microfinance in Latin America in 10 Years: Vision & Characteristics*. ACCION International, Boston.

Finally, Latin American countries have also implemented technological innovations in the more traditional understanding of technological devices and equipment. These technological devices reduce transaction and information costs if workers have the ability to take advantage of such resources. In addition, they can be instrumental in promoting use of services. For instance, empirical evidence from Bolivia and Peru demonstrated that reminders of savings through text messages increased savings and were more effective when they highlighted the importance of a specific expenditure.[14] For this reason, devices that help microfinance to be a business of scale, also called 'branchless banking', have become important, both internationally and throughout Latin America.[15]

For example, mobile banking, or mobile phone payment technologies that allow people to receive and transfer value in small amounts through the mobile phone network, is one example of a technology being adapted and used in the region. Biometrics, which measures physical characteristics of people to enhance security and thus increase confidence of people in credit, is also being used. For example, *Prondem Fondo Financiero Privado* (FFP) in Bolivia has experimented with these technologies and showed biometrics-equipped ATMs can lead to significant reductions in funding costs through expanded outreach.

Remote data processing, or the use of PDAs, smartphones and laptops that that facilitate client risk analysis to determine creditworthiness, has been demonstrated to have positive impacts, though under certain conditions. For example, *Compartamos* (Mexico) showed the early adoption of this technology is not recommendable without a stable management information system (MIS). PDAs also require mature loan products to avoid constant adjustments. However, with these conditions in place, ADOPEM, a programme in the Dominican Republic, experienced dramatic improvements from the use of PDAs.

Psychometric testing is a new and recent tool used in Latin America to diminish risks. It assesses the viability of small

[14] Gutierrez, Soares 2011, above n 8.
[15] Dermish, A. *et al.* 2011. Branchless and Mobile Banking Solutions for the Poor: A Survey. Innovations 6 (4) 99–104.; For additional examples, see the ELLA Brief: Latin American Innovations in Microfinance Technology.

and medium-sized enterprises for credit by focusing on attributes like ethics, integrity, personality and business skills. This initiative was launched recently by the Inter-American Development Bank (IDB) with the creation of a US$25 million facility that aims to grant loans and partial credit guarantees to Latin American financial institutions that adopt the technology.

More information about these and other technologies can be found in the [ELLA Brief: Latin American Innovations in Microfinance Technology].

RURAL MICROFINANCE

In 2010, about one fifth of the population in Latin America and the Caribbean lived in rural areas, a relatively low proportion when compared with other developing country regions, though still significant.[16] Poverty tends to disproportionately concentrate in rural areas: for example, 56% of Peruvians, 71% of Guatemalans, 46% of Colombians and 50% of Ecuadorians in rural areas were living below the rural poverty line.[17] At the same time, access to microcredit is the most limited in rural areas. Though the Latin American 'microfinance revolution' has been largely an urban phenomenon, recent developments suggest that rural areas are finally starting to benefit from microfinance as well.

This has required that microfinance practices and policies be adapted to the rural reality, especially in terms of risk management, products offered and lending technologies, again understood in a broader sense as the combination of human resources, processes and technological devices. So how is microfinance being implemented in Latin America's rural areas? One important characteristic is the make-up of agricultural and non-agricultural loans. An analysis of 42 financial institutions in Latin America with rural portfolios illustrates the preference for portfolio diversification between agricultural and non-agricultural activities: among successful microfinance ventures in rural areas, less that 40% of the total loan portfolio was agricultural.[18] The analysis also shows that when there is less diversification, meaning when agriculture portfolio shares are higher, delinquency rates are also higher.

The microfinance products offered in Latin America's rural areas also have distinct features compared to urban contexts:

1. Agricultural loans are larger and, due to seasonality, there are fewer repayments scheduled. Due to volatile returns on agriculture projects, the debt capacity of farm-dependent households is more constrained.

2. Regulated entities offer larger loans than non-regulated entities due to their larger capital base, since regulated entities can attract and mobilise deposits.

3. Most institutions tend to favour short-term working capital loans. Only 6.3% of regulated entities and 3.8% of non-regulated ones offered leasing, whereas 75% of regulated and 62% of non-regulated institutions offered fixed investment medium- and long-term loans.

4. The most common types of loans offered were individual, while group loans were a distant second; 91% of MFIs in rural areas offered individual loans, while 47% offered group loans. Village banking[19] was even less common, being offered by only 34% of institutions.

To learn more about microfinance in Latin America's rural areas, see the [ELLA Brief: Expanding Microfinance in Latin America's Rural Areas].

MICROFINANCE PLUS[20]

To promote enterprise development, many Latin American programmes have begun providing additional services - outside of loans - to help microentrepreneurs enhance their businesses. These interventions go back to the late 1970s and 1980s with attempts to train clients in managerial skills and business plans, though not going so far as providing direct advice on their businesses. Latin American research, such as a study by the IDB's FOMIN, suggest there is a particular demand

[16] This proportion is driven by the largest countries, such as Brazil and Argentina; in smaller or mediam-sized countries, the rural proportion of the population tends to be larger.
[17] IFAD. 2011. *Poverty Report 2011*. IFAD, Rome; World Bank Databank, poverty headcount ratio at rural poverty line (% of rural population) and rural population (% of total population) for Latin America and the Caribbean, 2011.
[18] Wenner, M. *et al.* 2007. *Managing Credit Risk in Rural Financial Institutions in Latin America*. Inter-American Development Bank (IDB), Washington, DC.
[19] Village Banking is a model of microcredit where neighbours in a poor community form a borrowing group and are asked to save a percentage of their loan. The only collateral is the fact that the other people in the group will have to repay in the case of noncompliance of one of the members. For more information, see: FINCA, IFAD. 2005. *Village Banks: The New Generation*. FINCA, Washington, DC.
[20] Goldmark, L. 2006. *An Inside view on Latin American Microfinance, Chapter 7: Beyond Finance: Microfinance and Business Development Services*. Inter-American Development Bank (IDB), Washington, DC.

for microfinance plus services, suggesting that these models should be emphasised in rural areas.[21]

MFIs acknowledge that training is important to overcome clients' various constraints, so there are many institutions that nowadays offer diverse complementary services, including both business development services and others, as well as health, literacy or legal services apart from financial training. These approaches may also include community development and women's empowerment; in terms of the latter, the organisation *Pro Mujer* has some interesting experiences to share from their work in Latin America, especially related to microfinance plus health services. The challenge of how to deliver such services, and knowing which services are most important, still remains; empirical evidence is not abundant and the microfinance plus model is still incipient.

Latin American microfinance initiatives are also implementing financial education, management training, technical training and assistance and market linkages. *Caja los Andes* in Bolivia and *Financiera Calpia* of El Salvador are two examples. Management training was a very common practice during the 1980s, and was based on providing courses related to inventory management, accounting, tax planning and legalisation. Although few MFIs provide this type of training nowadays, there are still some examples, such as *Financiera Solución* in Peru and ACCION in Colombia that has developed training modules that it sells to other MFIs in the region.

Technical training and assistance, aiming to teach about production techniques, new designs and the use of technology, is often associated with the agricultural sector and small producers in general. *Actuar Famiempresas* in Colombia offers one example; with support from the IDB's Multilateral Investment Fund (MIF), it developed a customised curriculum for technical assistance. The process involves a 15 hour assessment and 97 hours of consulting assistance to improve production processes, management and administrative procedures, sales, product quality, distribution channels and market positioning, with the costs subsidized 40% by *Actuar*.

Finally, market linkages are efforts to combine finance, information, skills and market access in one package, in order to help producers better organise so they can produce at a larger scale. It often includes access to credit and specialised inputs, access to technical assistance in production or processing to enhance quality, investments in infrastructure, and diversification of producers' distribution and sales options. Some interesting examples of these kinds of initiatives come from the Social Enterprise Program of the IDB.

Although, as mentioned, there is little empirical evidence on the impact of microfinance plus services, Karlan and Valdivia (2011)[22] conducted a randomised control trial measuring the marginal impact of adding business training to a group-lending programme for female entrepreneurs in Peru. Pre-existing lending groups were randomly assigned to either receive training and credit or to receive credit only. Although the authors concluded that the business training programme led to limited improvements in business knowledge, practices, and revenues, they did find some positive and significant effects for some indicators, including keeping records of withdrawals from the business, an index of business knowledge questions and investing profits back into the business.[23]

CONCLUSION

Microfinance institutions (MFIs) in Latin America are particular in that they have tended to operate more as private businesses, thus being subjected to everything that is asked from a business in terms of profitability and sustainability. The model is also different because it emerged through private non-profit institutions working in urban markets, originally focusing on the unmet demand for credit in the informal sector. The impressive growth observed in the last two decades is most associated with financial sector regulatory reforms, macroeconomic stability, available human capital and technological adoption. Innovation lives on, with the next frontier being incorporating business development services into microfinance.

[21] Multilateral Investment Fund (FOMIN). 2011. *Video: Rural Microfinance in Latin America and the Caribbean: What Works and What Doesn't?* FOMIN, Washington, DC.
[22] IKarlan, D., Valdivia, M. 2011. Teaching Entrepreneurship: Impact of Business Training on Microfinance Clients and Institutions. *The Review of Economics and Statistics* 93(2) 510-527.
[23] Gutierrez, Soares 2011, above n 8, 15.

CONTEXTUAL FACTORS

ENABLING LATIN AMERICA'S SUCCESSFUL APPROACH TO MICROFINANCE

Microfinance in Latin America emerged with a different approach: it looked to provide credit to the unmet needs of small business owners. In this context, the financial reforms of the 1990s were essential because they created an appropriate business environment that allowed microfinance to become a sustainable business through liberalised interest rates, developing into a business of growth and scale, and with the ability to undertake different operations.

Nonetheless, financial sector reforms were not the only element needed, since the target clients of microfinance in Latin America tend to be poor, do not keep business records, and have no reliable real guarantees. Regulations needed to be adapted to institutions offering microcredit, especially regarding risk management, products offered and institutional features. Overall, countries' capacities for implementing these various types of reforms created a strong institutional context within which microfinance could expand.

Adaptation of methodologies and products and services offered has played an important role in the success of microfinance. In Latin America, lending techniques and products offered vary according to the area and its clients. Although the dominant approach is individual lending, other approaches include group banking (Brazil, Colombia) and village banking (Mexico, Peru).

Technology also was key to facilitating microfinance's financial sustainability. Loan officers are trained to address clients' needs in the best possible way, and their abilities are enhanced through proper incentives. The level of trust achieved between the staff and clients, combined with a set of technologies that reduce transaction costs, make monitoring cost-effective and improve access to financing, is what make microfinance a profitable venture in Latin America.

LESSONS LEARNED

1. The Latin American microfinance model is different from other regions in that it has focused on developing profitable businesses by meeting the credit needs of entrepreneurs. This approach has facilitated competition among MFIs since they can make a business of microfinance, and thus has led to proliferation of institutions in Latin America seeking to satisfy market demand.

2. Specific policies and requirements vary from country to country, but a set of good regulatory practices in Latin America includes: minimum capital requirements; strict standards for related-party lending; increased access for MFIs to engage in more complex or risky operations subject to fulfilling more demanding requirements; ensuring adequate scale for efficiency; and promoting competition.

3. Strategies implemented in Latin America show that capital investments in technology are essential in order to reduce risks, but they need to be matched with proper organisational innovations that involve personnel management. Technological devices reduce costs, but it is loan officers who need to be capable of managing issues related to microcredit with the clients. Communication skills and mutual trust are essential where no guarantees exist.

4. The microfinance plus model that seeks to combine loans with training on different subjects, both financial and nonfinancial, still needs to be developed in Latin America, though initial evidence points to the model's effectiveness.

5. In spite of its importance and widespread implementation, evidence on microfinance's effectiveness in Latin America is limited, signalling a need for more and better research.

KNOWLEDGE PARTNERS

This is a sample of some of the key organisations researching, evaluating and implementing projects related to microfinance initiatives. For additional information on these and other organisations, read the ELLA Spotlight On Organisations: Microfinance in Latin America.

ACCION Latin America

This international non-profit organisation works in Latin America seeking to provide MFIs in the region the necessary tools to enhance their business and thus increase outreach of financial services to the rural poor. The microfinance services they offer include management services, investment, innovation and governance support.

Consultative Group to Assist the Poor (CGAP)

CGAP is an independent policy and research organisation based at the World Bank. Through research, outreach and advocacy, it aims to support poor people's access to finance. Though focused internationally, CGAP has conducted research and carried out other activities focusing specifically on Latin American countries. Their organisational blog also often focuses on Latin America, offering interesting features on regional trends and specific countries.

Inter-American Development Bank (IDB)

The IDB provides funding for Latin American countries to strengthen microfinance regulation and expand access, and they also conduct research about a variety of microfinance topics. In fact, the IDB is probably one of the largest sources of publications about microfinance in Latin America. They publish not only theoretical publications, but also case studies about the microfinance programmes they are funding, like the Social Entrepreneurship Program, which supports programmes related to rural finance and access to basic services.

Microfinance Information Exchange (MIX) Market

This non-profit organisation is an important source of up-to-date information about microfinance institutions, funders, other key microfinance actors and indicators on sector performance. MIX aims to be the first source of objective, relevant and quality microfinance performance data and analysis. They also accumulate and publish a wealth of information about Latin America. Not only are publications and regional analysis made continuously, but readers can create their own reports by selecting relevant indicators or focusing on specific countries or regions;

Multilateral Investment Fund (*Fondo Multilateral de Inversiones* - FOMIN)

FOMIN, a member of the Inter-American Development Bank (IDB), focuses on supporting private sector development, and includes a significant amount of work on microfinance and access to finance more generally. They conduct and publish a variety of research, from theoretical documents to empirical evidence and reports on the Latin American microfinance market and on projects related to improving financial inclusion. Their MicAmericas knowledge platform, published in English and Spanish, houses additional research and publications.

Pro Mujer

Based in New York City, *Pro Mujer* (meaning Pro Woman in Spanish) is an innovative microfinance organisation dedicated to providing access to finance for women in Latin America, working primarily in Argentina, Bolivia, Mexico, Nicaragua and Peru. The *Pro Mujer* approach combines providing microfinance to poor women with other services such as health services, training and basic financial education. *Pro Mujer* has a YouTube channel and many English publications documenting their approach and experiences.

RECOMMENDED READING

Here is a selection of some of the key publications related to microfinance in Latin America. For additional information about these and other references, read the ELLA Spotlight on Publications: Microfinance in Latin America.

Berger, M. *et al*. 2006. *An Inside View on Latin American Microfinance*. Inter-American Development Bank (IDB), Washington, DC.

Goldberg, M., Palladini, E., 2010. *Microfinance: Managing Risks and Creating Value, Results of a South American Dialogue*. World Bank, Washington, DC.

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Navajas, S. *et al*. 2007. Managing Credit Risk in Rural Financial Institutions in Latin America. Inter-American Development Bank (IDB), Washington, DC.

LEARN MORE FROM THE ELLA BRIEFS

These four ELLA Briefs focus in on key aspects of the story of microfinance in Latin America:

Latin America's Institutional and Regulatory Innovations for Microfinance Growth

Before the 1980s, the microfinance sector was virtually non-existent in Latin America, but now it grows at two-digit rates. How have institutional innovations played a role in this expansion?

Latin American Innovations in Microfinance Technology

In Latin America, innovations in microfinance come not only from new technology, but by focusing on the people and processes making use of that technology, achieving important advances in scale and reach.

Expanding Microfinance in Latin America's Rural Areas

Rural finance has the potential to help poor people out of poverty, and Latin America has met that challenge in some unique ways.

Peru's Microfinance Sector and the *Caja Municipal* Model

The experience of Peru's *Cajas Municipales* illustrate a potential growth path for microfinance firms and point to key lessons for sector development overall.

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To learn more about microfinance in Latin America, read the rest of the ELLA knowledge materials on this theme. To learn more about other development issues, browse other ELLA Themes.

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