Women's World Banking

Individual Lending to Microenterprises in Mexico: An Overview of Constraints and Opportunities

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women's world banking is the global non-profit devoted to giving more low-income women access to the financial tools and resources essential to their security and prosperity. For more than 35 years we have worked with financial institutions to show them the benefit of investing in women as clients, and as leaders. We equip these institutions to meet women's needs through authoritative market research, leadership training, sustainable financial products and consumer education.

Background

Women's World Banking has followed the development of the microfinance market in Mexico for several years, wondering, as the rest of the industry has, why microenterprise lending has not taken off in the country despite its large population and microfinance market. With support from McGraw Hill Financial, Women's World Banking sought to gain a better understanding of the challenges and opportunities for financial institutions to offer individual microenterprise lending to low-income entrepreneurs in Mexico. This report highlights findings that we hope will spur financial institutions reach this underserved market.

Mexico is a middle-income country and is one of the most populous countries in Latin America. There are more than six million microfinance borrowers in Mexico, the largest number of borrowers in the region with nearly 5,000 financial services providers serving this market. When compared to its regional peers, Colombia and Peru, however, Mexico has the smallest loan portfolio (US$ 3.8 billion compared to $ 6.8 billion and $ 10.2 billion, respectively). Given the number of borrowers, this implies a small average loan size primarily provided through the group lending approach—a stark contrast to its regional peers who predominantly offer individual credit to microentrepreneurs.

Nevertheless, individual lending does exist in Mexico but is distinct from its neighbors in a few ways. First, salaried individuals (not just microentrepreneurs, typically defined as a business owner with 10 employees or less) also access these loans. Second, microfinance institutions are not the only ones offering these loans: a range of financial service providers, such as retail banks, cooperatives, supplier credit and pawnshops also do. And lastly, individual loan applicants are assessed primarily through credit history and/or credit scoring in Mexico instead of rigorous business and household risk assessment.

Despite the large number of both borrowers and service providers, 80 percent of the market is served by just six institutions. The market leader, Banco Compartamos, controls over a third of the market. And while the microfinance markets of Latin America are either growing or saturated, Mexico's appears to be shrinking, losing 50,000 borrowers in 2012 (MIX Market).

Lending for microenterprises: group vs. individual

Group lending through village banking or solidarity groups, long the hallmark of providing financial services for low-income people, is the dominant model in Mexico to reach both low-income entrepreneurs and non-entrepreneurs. It supports consumption (everyday goods such as school fees, household goods etc.), income smoothening and to a limited extent, business growth. These groups receive a loan of about $500 on average, with an interest rate of 80 to 120 percent for up to six months.

While the group lending methodology provides a great entry point for the unbanked into the formal financial sector, it does not serve microenterprises well as they grow. These loans are, by their nature, limited by the group's collective capacity to repay. Thus they are often smaller in size and not conducive to keeping pace with growing businesses. Furthermore, character assessment, the credit analysis process underlying group loans, reveals nothing about an individual's need or capacity to repay. A financial institution effectively shifts risk—and with that the responsibilities of loan risk assessments— to the group. A more robust business and household risk-assessment is good practice for microenterprise lending. And while it may come with increased loan processing costs, it presents a benefit for institutions in the process: the opportunity to cross-sell other financial products[1].

The benefits of individual lending for microentrepreneurs seeking business growth include:

- *Loans that fit their business needs*: Group loans are traditionally used for basic household needs, income patching, and smaller enterprises. There are limitations to how much a group loan can expand enterprises. Because individual loans are based on a better "know your customer" process and comprehensive risk analysis of the borrower's business, these loans are usually larger in size (to address the capital needs of the business) and have more flexible loan conditions (i.e., grace periods, repayment frequency, loan terms, top ups), allowing poor people to grow their businesses. It also allows the borrower to build a risk-based credit history with the institution.
- *Convenience*: Established entrepreneurs often do not want to continue with group lending. They are more likely to be inconvenienced when repeat loans are suspended or delayed due to delinquency within the group. A common criticism of group lending is that meeting attendance requires time that members—especially mature customers—may not be able to spare.

In addition, individual lending can also reduce overindebtedness in the local microfinance market. Recent stress in regional and national microfinance sectors worldwide has highlighted the risks of rapid growth in financial services without sufficient staff or institutional capacity. Loan delinquency crises and high rates of over-indebtedness in Nicaragua, Morocco, Bosnia-Herzegovina, Pakistan, and Andhra Pradesh in India all followed a period of unprecedented expansion of services, often resulting in clients accessing multiple loans. During these periods, internal controls, risk management, and staff quality deteriorated and incentives in the organizational culture were aligned to a high-risk, high-growth, high-return strategy[2]. Individual lending, in conjunction with established industry infrastructure such as credit bureaus, offers a possible solution in these markets, because careful, individual-focused evaluation processes provides more information about the client and assesses her ability to repay a loan, thereby helping to reduce over-indebtedness.

[1] Venkata, N.A., Anup Singh, and Trevor Mugwanga (April 2010). "Breaking the Barriers: Market Expansion through Individual Lending." MicroSave Briefing Note #88.

[2] Chen, G., S. Rasmussen, and X. Reille (2010). Growth and Vulnerabilities in Microfinance, CGAP Focus Note 61. CGAP, Washington DC.

With Mexican government initiatives seeking to foster financial inclusion, a variety of legal structures in place to offer financial services and a sizeable un- and under- banked population, an obvious question emerges: **what has constrained the growth of traditional individual microenterprise lending in Mexico?**

To answer this question, Women's World Banking interviewed key representatives from government, financial services providers, industry organizations and financial inclusion experts, complementing these findings with publicly available data. Women's World Banking also conducted focus groups with microentrepreneurs in Mexico City and Zacatecas (sites chosen to represent the range of economic activities and availability of financial services providers in the country). Understanding the perspectives of both industry and client is critical to reach a holistic view of the challenges facing the microfinance industry.

Women's World Banking brings a decade of experience working with institutions as they move from a group lending model to begin offering individual loans based on an analysis of business income. We have supported the introduction of individual lending in more than ten institutions worldwide[3]. Our most recent work includes support to three institutions in Latin America to adapt individual lending to rural clients.

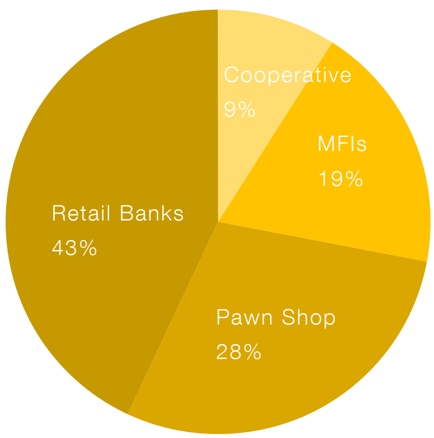
This assessment was not related to a specific product introduction with a financial institution but rather a general market scan. It did not have an explicit gender focus but it is important to note that 80 percent of Mexico's microfinance borrowers are women, thus the development of microenterprise individual lending will affect women's access to finance.

[3] Women's World Banking's approach to integrating individual loan products into group lending institutions is discussed in *Product Diversification in Microfinance: Introducing Individual Lending* available at http://www.womensworldbanking.org/publications/product-diversification-microfinance-introducing-individual-lending/

The Industry Perspective

Consumer credit[4] has acted as a substitute for microenterprise lending

The availability of credit, particularly in the form of consumer loans, is high in Mexico. Mexicans use credit both to facilitate consumption and to invest in their businesses. More than 70 percent of the credit extended in the market for low-income individuals is from retail banks and one national pawn shop chain. In contrast, credit from MFIs represents just 19 percent of the total available credit.

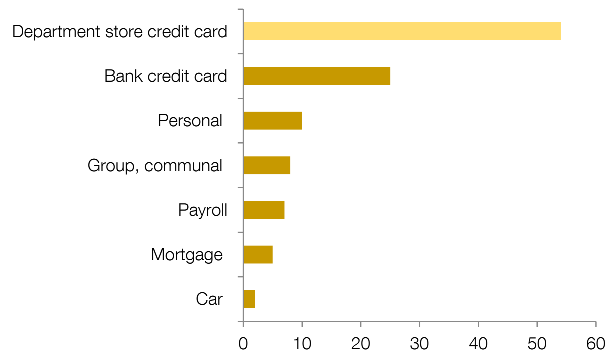


Total Credit Market: MEX 183,494,131,466
US $ 13,953,926,347

Source: Prodesarrollo, CNBV,

Casa de Empeno = Nacional Monte de Piedad website

Perhaps most tellingly, credit cards are extremely popular in Mexico. More than 50 percent of the adult population have access to a department store credit card and 25 percent have access to a bank credit card[5] . In comparison, bank credit card usage by the overall adult population is 10 percent in both Perú and Colombia[6]. As a result, the Mexican population is more familiar and/or comfortable with using consumer credit as the primary financial product to help meet their personal and business needs.



Source: ENIF - CNBV, National Survey for Financial Inclusion 2012

The group lending model has been the dominant approach

As a highly successful market leader, Banco Compartamos has defined the current model of microfinance in Mexico. They have proven that their village banking model, targeting the lower income market, is financially viable, profitable and able to reach scale. Their success has led others to adopt the same approach, resulting in limited incentives to innovate on financial products and services. Because most financial service providers offer a similar product through a similar methodology, the credit available is very much a "one size fits all" product. Borrowers seeking loans for consumption or to build their business receive loans with similar terms and repayment schedules regardless of whether these terms or schedules match their ability to repay.

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[4] Consumer credit is defined as a debt that someone incurs for the purpose of purchasing a good or service. This includes purchases made on credit cards, lines of credit and some loans

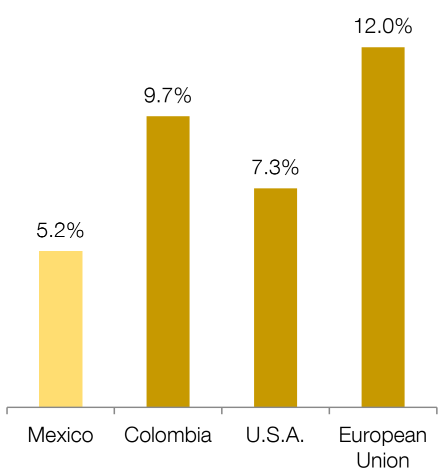
[5] ENIF – CNBV, National Survey for Financial Inclusion 2012, p. 25

[6] World Bank, Global Findex Database, April 2012

Human resources in Mexico pose unique challenges to the growth of microenterprise lending

Employee retention rates, especially for loan officers, are low in Mexico. While retention rates vary by region, staff turnover for all MFIs in the country was 46.3 percent on average in 2012, almost double the Latin American average of 24.5 percent for the same time period. According to interviewees, field work is perceived to be too difficult and most graduates coming out of college are looking for desk jobs with minimum physical duress. In addition, microfinance is not considered to be a prestigious industry and it has been challenging to both attract and retain employees. On the other hand, due to stringent labor laws that favor employees, it is also difficult and expensive to let go of underperforming employees.

Another important reason for turnover is the dynamic labor market. Again, unlike its peers in the region, unemployment in Mexico is low at 5.2% (as reported for the third quarter of 2013). Employees are quick to change jobs for small increases in salary and fewer physical demands.



Source for Mexico: INEGI 2013

Source for Colombia, U.S.A. and E.U.: CIA Factbook, 2013 estimates, European Commission - Eurostat statistics

Regulation has served as a disincentive to banking institutions in promoting growth of microfinance

Current regulation states that financial services providers that offer loans classified as microenterprise loans to clients with no credit history are expected to maintain 100% loan reserve. If, however, the loan is classified as a consumer loan, no reserve requirements are necessary, making it much easier and much more attractive for banking institutions to offer consumer loans. This policy has inadvertently promoted the further growth of consumer finance while simultaneously inhibiting the development of microenterprise lending.

The Customer Perspective

Similar to clients in other markets, microentrepreneurs in Mexico cite access to capital as a key enabler for business growth. Participants in our focus groups, particularly those with access to loans, expressed the need for credit, either to start or to grow a business. Men and women with access to loans recognize the advantages of using loans and regard them as a useful tool when there is no other immediately available source of capital. Non-borrowers used their own savings and/or severance pay to invest in their business. In general, participants cited four main reasons for using loans to open, upgrade or expand their businesses:

- To *complement* savings or severance pay for the initial investment;
- To take advantage of an *opportunity to acquire a business* either from a relative or previous employer;
- To deal with *unforeseen circumstances* (dismissal without compensation, death of provider, disability) that force the individual into starting a business; and
- For *investment capital* – to buy supplies or expand a business. Some borrow from financial providers while others get in-kind credit from suppliers.

Despite the need for capital, microentrepreneurs face serious challenges in accessing formal loans.

Clients have low levels of financial literacy

There is no one clear definition of the term "financial services" in the minds of our focus group participants. Focus group participants did not perceive a difference among types of financial service providers and do not differentiate between capital loans, consumer loans, credit cards and pawn loans. Consequently, there is often confusion about the words "loan" and "credit".

In Mexico City and Zacatecas, loans are defined as money provided in "cash," whereas credit may be used for goods, inputs or through a card. In comparison, most of the global microfinance industry uses the terms "loan" and "credit" interchangeably.

> *"A loan is cash, a credit is when you take the stove home and you pay for it on installments."* - MAN WITH FINANCIAL ACCESS, ZACATECAS

> *"A credit is a fixed payment for buying something. When it's a loan, they give you money and you pay faster."* - WOMAN WITH FINANCIAL ACCESS, MEXICO CITY

The need for financial literacy is evident and clearly expressed by many participants. They consider financial education a much needed service and to their knowledge, only a few institutions provide it. Participants were eager to receive an orientation on credit products, with clear explanations of the full process of applying for a loan, alongside terms and conditions.

> *"That they are able to orient you (provide guidance); how much you are going to pay, because later on they also get confused."* - WOMAN WITH FINANCIAL ACCESS, MEXICO CITY

Nevertheless, participants that were borrowing from financial services providers at the time did acknowledge that they would not have been able to achieve what they currently have without access to loans.

> *"We have what we have because of loans, only loans.* - WOMAN WITH FINANCIAL ACCESS, ZACATECAS

Focus group participants without access to financial services cited several barriers mostly linked to transparency of information regarding financial services providers and products.

There is no clear understanding of how loans operate and the requirements needed to apply for credit. Furthermore, any information they have about such services is partial or based on biased information.

Many fear not being able to honor a loan obligation while others regard financial providers as "money eaters" who look for their own benefits regardless of people's well-being. The perception that loan applications and approvals are complex procedures that require a guarantor to mortgage a property; show income receipts; and demonstrate a credit record prevail among people who have never approached a financial organization.

Lack of appropriate products coupled with low levels of financial literacy have resulted in over-indebtedness

Rates of over-indebtedness in Latin America have been rising in recent years and Mexico has a particularly high rate: a survey of their Mexico branches by FINCA, a global microfinance network, found that about three out of four applicants had existing loans and 60 percent of individuals with two loans were behind in payment—a rate that increases to 80 percent among individuals with four existing loans[7]. While Women's World Banking's research did not focus on over-indebtedness, responses from participants with access to credit indicated that over-indebtedness is an issue they currently face or fear.

The "one size fits all" approach in Mexico has resulted in an industry offering that does not match the needs of the low-income customer who already lacks the financial literacy to navigate the often opaque financial options available to her. A destructive cycle of debt often ensues.

"I fell in arrears with [Institution A], I couldn't catch up and I wanted to negotiate but they wouldn't lend me money. So to get out of the problem I joined a savings group at Institution B. I have used almost all my money there. I also applied for a loan with Institution C. I am deeply in debt…"
- WOMAN WITH FINANCIAL ACCESS, ZACATECAS

[7] Ericksen, J., Ericksen, E. and Graham, S. "Over-indebtedness in Mexico: Giving Borrowers A Voice" FINCA 2014. 1, 6

Clients associate strong feeling of mistrust and fear with financial services in Mexico

Among microentrepreneurs interviewed through the focus groups, there is a strong feeling of mistrust and fear associated with financial services in Mexico. The term "financial services" triggers immediate negative associations, including debt, high interest rates, pressure, time limits, complications, stress, trouble and fear. The predominantly negative perception about financial services is one of the key barriers that keep participants from applying for business loans. This mistrust expands across a wide range of service providers including microfinance organizations, department store credit cards, savings groups, loan sharks, banks and pawn shops, the last two particularly in Mexico City.

"(Credits) are a scam; you end up paying a lot more."
- WOMAN WITH FINANCIAL ACCESS, MEXICO CITY

"Everything that is loan or credit is fraud; that is why I do not go near it."
- MAN WITHOUT FINANCIAL ACCESS, MEXICO CITY

"It's like being addicted to credits. It's better to live within one's own means. Imagine to get a debt not knowing if you can pay back or not."
- WOMAN WITHOUT FINANCIAL ACCESS, ZACATECAS

Given these negative perceptions, applying for a loan either to start or capitalize their business was not a priority for any of the participants. Many started their businesses with their own savings or severance pay after having been laid off from their jobs or family support (in-kind or cash). Only those who did not have other options opted for getting a loan to start a business.

"That's why we did everything we could to get a loan and take the business over. We had nowhere else to go."
- WOMAN WITH FINANCIAL ACCESS, ZACATECAS

"I used my severance money."
- WOMAN WITHOUT FINANCIAL ACCESS, MEXICO CITY

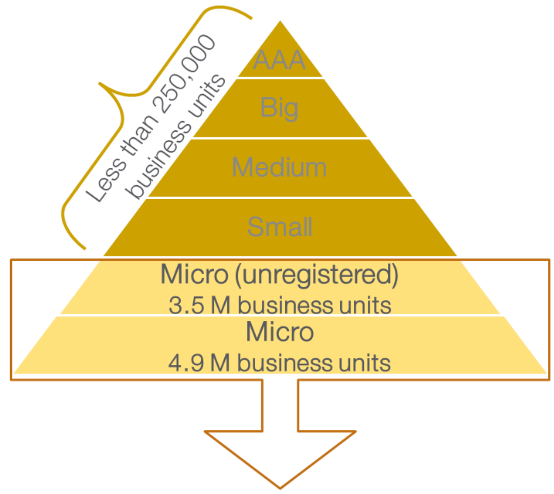
Outlook

Despite these challenges, proponents of financial inclusion in Mexico see an opportunity for the financial services industry. Our industry interviewees were nearly unanimous in saying that there is limited opportunity for further growth in group lending. **The future is in microenterprise individual lending.**

The findings from the industry analysis and customer research clearly indicate that the microenterprise lending segment is an overlooked market not optimally served by financial services providers today. The limited growth opportunity in group lending and the opportunity to target a new segment is being recognized by most players in the industry[8] . There is excitement and momentum to offer a new product with a new approach.

There are approximately 9 million business units in Mexico of which about 5 million are registered or have taxpayer IDs. Of the registered businesses, the majority are defined as "micro" (based on number of employees, 0-10).

Women's World Banking estimates[9] that there is a a market of approximately 2 to 2.5 million microentrepreneurs who are unserved by individual lending based on business analysis and repayment capacity. Reaching these microentrepreneurs with appropriate products would expand the local microfinance market and meet the business needs of microentrepreneurs.



	Units	Assumption of Already Served	Potential to Still Serve	50% Market Penetration
Micro-registered	4,897,141	20%	3,917,712	1,958,856
Micro-unregistered	3,466,796	70%	1,040,038	520,019
Total market opportunity				2,478,875

Source: IABM, NEGI, Censos Economicos 2009

[8] Source interviews

[9] Assumptions include:

- 20% of micro-registered businesses are already being served
- 70% of micro-unregistered businesses are already being served
- 50% of potential market can be penetrated

The Path Forward

With limited growth opportunity left in the group lending model, financial services providers are turning to offering microenterprise lending, a trajectory that will be heavily influenced by the market leader. Given the current state of microlending in Mexico, Women's World Banking sees that over-indebtedness in the market will result in lenders taking a more cautious approach when providing debt. Retailers will be more likely to adopt greater rigor when analyzing the risk associated with lending to avoid multiple borrowing and increasing portfolio risk. Finally, as the two credit bureaus, Buró de Crédito and Circulo de Crédito, increase collaboration, the use of credit bureau information by financial service providers will continue to increase.

Based on Women's World Banking's extensive experience developing financial products tailored to meet the needs of low-income clients, particularly women, we see the following three elements as essential for a successful microenterprise lending program in Mexico.

Appropriate Product Design

First and foremost, products must be tailored to meet the needs of the target segment, namely micro-entrepreneurs. Loan sizes, interest rates and terms should be tailored to business cash flow and loan analysis as well as take into account the economics of the entire household unit. Collateral requirements need to be adapted to existing assets, and reasonable alternatives should be clearly identified for those that require flexibility.

Tailored Marketing and Financial Education

In order to reach microentrepreneurs effectively, institutions need to embed financial education in all marketing and communication strategies. Product benefits and terms should be transparent and articulated in language understood by clients and tailored to their levels of literacy. Investing in financial education and training in money management would yield longer term results, including building trust in the financial services providers. Women's World Banking has tested several approaches to financial education which are outlined in the report, *From Access to Inclusion: Educating Clients*[10].

Efficient Operating Model

Beyond developing and marketing a product, successful microenterprise lending requires an institution-wide commitment by the financial services provider. Not only will a solid cash flow-based individual lending methodology have to be implemented, but credit risk analysis must be built at all levels of the institution. Staff will need to be trained to ensure proper loan analysis; field training must be based on clear procedures and technology that supports efficient data collection and decision making. Adapting the training curricula, benefits, and salary scale to the profile of the loan officers and defining incentives (monetary or otherwise) will increase staff retention. In addition, performance management systems will need to be adapted to optimize staff productivity, efficiency and controls. Monitoring these results will enable institutions to assess the sustainability and potential of focusing on microentrepreneurs, and build a robust business case for targeting this segment. Women's World Banking is working with MFIs in the Middle East and South Asia to adjust their operations, delivery channels, information systems and marketing to better suit the roll-out of a new women-focused individual lending product.

With the opportunity identified in this market and Women's World Banking's experience in developing individual credit products for women, we see enormous potential to grow the financial services sector in Mexico and expand outreach to an under-served market segment by providing financial services that meet clients' needs.

[10] http://www.womensworldbanking.org/publications/access-inclusion-educating-clients/

Acknowledgements

Women's World Banking would like to acknowledge the invaluable input of representatives from ABM, Afirme, Banco FAMSA, Banco Compartamos, Banco Forjadores, BanCoppel, Círculo de Crédito, COLCAMI, Condusef, CNBV, DAI, Financiera Independencia, Fincomún, Podemos Progresar, Pro Mujer, PRONAFIM, Solución Asea, Te Creemos, and Prodesarollo. Market research was conducted by SIMO.

We also extend a special thank you to Union de Instituciones Financieras Mexicanas,A. C. (UNIFIM, A. C) for introducing Women's World Banking to many of the above institutions. Their support was instrumental to completing this work.

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