

# **Peru: Microfinance Investment Environment Profile**

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## **Methodology**

The central objective of this workshop report is to contribute to the information available to commercial investors interested in the microfinance sector by creating a framework for assessing the country-specific investment risk of commercial investments in microfinance and secondly, by identifying incentives and disincentives for MFIs to disclosing information important to investors. The Peru team spent 12 weeks in Princeton reviewing existing literature on the microfinance sector and one week in-country on fieldwork in and around Lima.

The fieldwork component consisted of interviewing key institutions in the Peruvian microfinance sector namely, MFIs, microfinance associations, relevant government agencies, commercial banks, microfinance rating agencies, investment funds and credit bureaus. The team also made on-site visits to MFI branch offices to observe client meetings and debt collection procedures.

## Abbreviations

CMAC	<i>Cajas Municipales de Ahorro y Credito</i>
COFIDE	<i>Corporacion Financiera de Desarrollo S.A.</i>
COFOPRI	<i>Comisión de Formalización de la Propiedad Informal</i>
COPEME	Consortium of Private Organizations that Promotes the Development of Small and Medium Enterprises
CRAC	<i>Cajas Rurale de Ahorro y Credito</i>
EDPYME	Small Business and Microenterprise Development Institution
FDI	Foreign Direct Investment
FEPMAC	<i>Federación de Cajas Municipales</i>
GDP	Gross Domestic Product
IMF	International Monetary Fund
MFI	Microfinance Institution
NFPS	Non-Financial Public-Sector
NGO	Non Government Organization
SBS	<i>Superintendencia de Banca y Seguros</i>
SME	Small and Micro Enterprise
UNCTAD	United Nations Conference on Trade and Development
USAID	United States Agency for International Development
VAT	Value Added Tax

## **I. Country Profile**

### ***Political Climate***<sup>1</sup>

Peru has seen dramatic change over the past two decades, bringing stability, prosperity and growth. The hyperinflation, high economic deficits and political turmoil of the 1980s have since been effectively addressed, making it one of the fastest growing countries in Latin America.

While President Alejandro Toledo's tenure has been tenuous, he is expected to complete his term ending July 2006. Corruption and electoral fraud charges seriously undermine his credibility. Yet, the center-left opposition led by Mr. Alan Garcia seems willing to see Mr. Toledo complete his term, even as they now call the shots and leave the President with limited control of the legislative agenda. There is suspense over what the next regime will bring, and the ramifications of that change. In the interim, there is concern that in an attempt to bolster their future chances the government will resort to populist politics. An example is a recent royalty tax on mining approved by the Congress and signed by the President that progressively increases with volume of sales, and drew the ire of private sector. In this context, there is worry that foreign investors may also find a less "hospitable" climate. As is discussed in Section VI, populist politics can be a source of risk to microfinance institutions (MFIs) as debt bailouts to placate important constituencies or pressure to extend additional credit during election campaigns can threaten the health of MFIs.

The Shining Path activity has now reduced considerably, even if there is speculation that they are merely regrouping at present. Border dispute with Ecuador was also settled with the 1998 peace agreement, which in fact, also encourages private investment flows via the Bi-national Integration Plan. An agreement concluded with Bolivia in 1992 gives access to the Pacific Ocean, and the anticipated access for Peru to the Atlantic Ocean through Brazil.

Despite political uncertainty, there seems to be some confidence that Peru will continue on its current economic trajectory. On 8 June 2004, the Standard & Poor's credit rating agency raised Peru's rating two notches in acknowledgment of the country's strong economic performance, and, one day later, the IMF agreed to a new US\$423 million loan deal to replace a previous arrangement that expired in March.

### ***Economic Climate***<sup>2</sup>

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<sup>1</sup> See International Country Risk Guide Report, August 2004

<sup>2</sup> See Economist Intelligence Unit ; Doing Business and Investing in Peru, Pricewaterhouse Coopers, 2003, <http://www.pwcglobal.com/pe/spa/pdf/DoingBusiness2002EN.pdf>; UNCTAD Report : Investment

Responding to the 1980s economic crisis, Peru has undergone a far-reaching process of structural adjustment and stabilization. This has been achieved by lowering trade barriers, opening the economy to foreign investors, providing a solid fiscal and monetary base, containing inflation and sound exchange rate policies in the new free floating Nuevo Sol currency (though the central bank intervenes to prevent major fluctuations). The dollarization of the economy that was undertaken to bolster confidence during the 1980s is now slowly being reversed.

<b>Select Economic Indicators for Peru</b>					
	2003	2002	2001	2000	1999
<b>Monetary</b>					
Inflation rate	2.26%	0.19%	1.98%	3.67%	3.47%
Lending rate	14.21%	14.73%	20.43%	27.91%	30.79%
Treasury bill rate	n/a	n/a	n/a	n/a	n/a
<b>Output and Income</b>					
GDP (current US\$; thousands)	61,010,930 <sup>a</sup>	56,517,060	53,639,110	53,044,270	51,372,450
Real GDP growth <sup>b</sup> (annual %)	4.0%	4.8%	0.3%	2.8%	0.9%
Budget balance <sup>b</sup> (% of GDP)	-1.8%	-2.2%	-1.8%	-1.9%	-2.3%
GNI per capita, Atlas method (current US\$)	2150 <sup>a</sup>	2,020	1,970	2,080	2,050
<b>Exchange Rates and Foreign Investment</b>					
Exchange rate (Soles per US\$; end of period)	3.46	3.51	3.44	3.53	3.51
Total foreign debt <sup>b</sup> (% of GDP)	48.3%	49.3%	50.7%	52.3%	51.4%
Foreign direct investment, net inflows (% of GDP)	n/a	4.23%	2.13%	3.78%	1.53%

Source: The MIX Market: <http://www.mixmarket.org/>

<sup>a</sup>The World Bank Group

<sup>b</sup>International Country Risk Guide (ICRG)

Comprehensive tax reform was implemented by an autonomous revenue agency, SUNAT, leading to a recovery in the tax-to-GDP ratio, while expenditure on subsidies to state-owned enterprises and import-competing firms was cut. These fiscal reforms allowed for a doubling in social expenditure as a percent of GDP over the 1990s. This process effectively opened the economy to private enterprise, *reducing the state's role in productive activities and redefining it as a regulator*. The 1993 Constitution strongly

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Policy Review, 2000 [http://www.unctad.org/en/docs/iteiipmisc19\\_en.pdf](http://www.unctad.org/en/docs/iteiipmisc19_en.pdf); Credit Bureaus and the Rural Microfinance Sector: Peru, Guatemala, and Bolivia, December 2003, FAO-University of California at Berkeley: [http://are.berkeley.edu/~sadoulet/papers/Final\\_report\\_FAO.pdf](http://are.berkeley.edu/~sadoulet/papers/Final_report_FAO.pdf)

encourages private initiatives. The government consciously seeks to attract investment, both foreign and domestic in most sectors of the economy. All government holdings in fisheries and the financial sector, more than two-third in mining, oil and communications and also in electricity and distribution have been privatized. Peru has been successful in attracting FDI- by 1996 it had joined the league of top 10 recipient of FDI among developing countries<sup>3</sup>.

According to the World Bank<sup>4</sup>, immediately after the 2001 elections, tax amnesties and exemptions continued to proliferate, there were increases in public sector wages and pension and privatizations came to a halt. The fiscal situation deteriorated markedly and, in 2000, for the first time in a decade, the fiscal performance criteria agreed with the IMF were not met. The Asia-Russia-Brazil financial crises, along with the effect of the El Nino, highlighted fragilities in Peru's banking sector, as government deposits were used to support financially weak but politically powerful banks. "Economic growth declined partly for exogenous reasons and partly because of policy deterioration".

Nevertheless, after years of inconsistent economic performance, the Peruvian economy has of late been one of the fastest growing in Latin America, with growth rates of 5 percent in 2002 and 4 percent in 2003, and the exchange rate has been stable with an annual inflation lower than 2 percent (CIA). Currently, Peru has record levels of international reserves, high export earnings and prudent macroeconomic management. Trade surplus of US\$2bn is predicted in 2005-06 (EIU). The Banco Central Reserva del Peru (the Central Bank) targets an inflation rate of 1.5-3.5 percent. (GRAPHS – across countries)

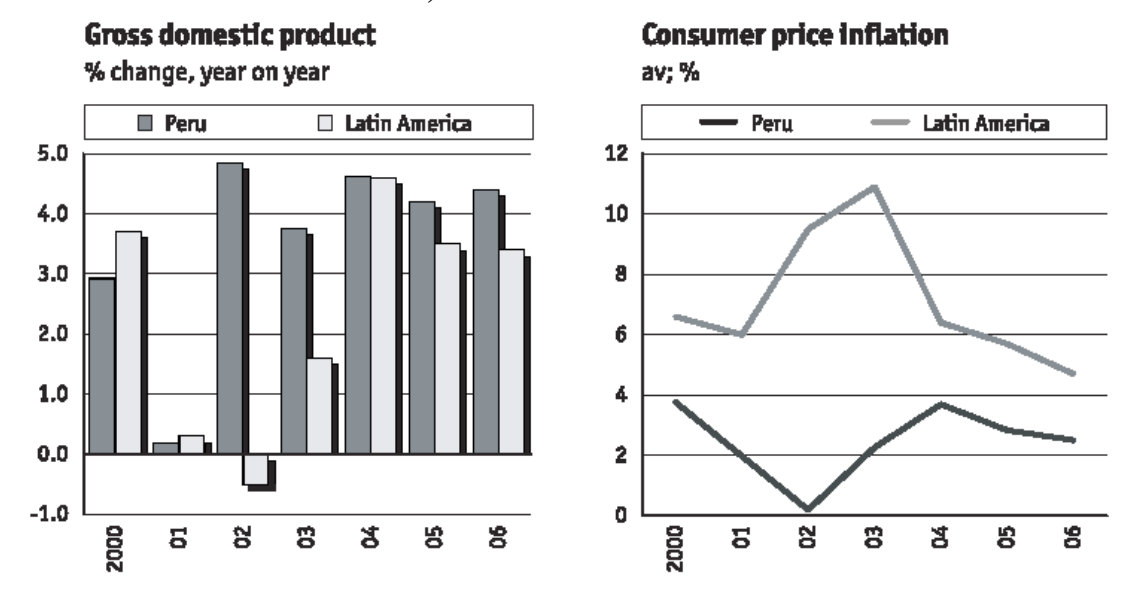
The government, in its 2005 draft budget predicts 4.5 percent growth rate, an average consumer price inflation of 2.5% and an overall NFPS deficit of 1.0% of GDP, down from a budgeted 1.4% of GDP in 2004. *The main macroeconomic assumption is that of a "bias against public investment."* Peru currently has one of the lowest public investment in the world, averaging only 2.8 percent of GDP, and is also significantly less than its own average of 5 percent of GDP in the mid-1990s. (EIU)

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<sup>3</sup> UNCTAD, 1999

<sup>4</sup> Peru Country Assistance Evaluation, World Bank, Sept 2002, [http://inweb18.worldbank.org/oed/oeddoelib.nsf/DocUNIDViewForJavaSearch/4E0549D96B7EC59D85256C6A00601D7C/\\$file/Peru\\_CAE.pdf](http://inweb18.worldbank.org/oed/oeddoelib.nsf/DocUNIDViewForJavaSearch/4E0549D96B7EC59D85256C6A00601D7C/$file/Peru_CAE.pdf)

## Peru, GDP and Inflation Trends



Source: EIU, 2004

There has been an appreciation in the exchange rate since 2003, caused by an over-supply of US dollars in the local economy. This has been due to combination of factors, including a strong and rising trade surplus, a sharp rise in remittances from migrant workers abroad, steady foreign direct investment (FDI) inflows and net external financing by the public sector.

### *Key Economic Activities* <sup>5</sup>

The country is rich in mineral resources, with output increasing by 5.9 percent in 2004. In years when mineral and commodity prices are high, about three quarters of foreign exchange earnings come from exports of minerals, fishmeal, oil, and semi-processed agricultural products such as cotton, coffee, and sugar. This dependence on the export of primary products exposes the economy to shocks from volatile commodity prices and weather conditions. In the past commodity shocks, in particular the 1998 El Niño Crisis, have had an impact on the profitability and stability of both the formal and informal financial sectors.

<sup>5</sup> Economist Intelligence Unit: [www.eiu.com/schedule](http://www.eiu.com/schedule); CIA World Fact Book: <http://www.cia.gov/cia/publications/factbook/geos/pe.html#Econ>;

## Peru, GDP Breakdown

Origins of gross domestic product 2003	% of total	Components of gross domestic product 2003	% of total
Services	55.0	Private consumption	71.0
Manufacturing	14.6	Gross fixed investment	17.9
Agriculture, livestock & forestry	8.8	Exports of goods & services	17.7
Mining & hydrocarbons	6.6	Government consumption	10.1
Construction	4.9	Stockbuilding	0.9
Fisheries	0.4	Imports of goods & services	-17.6

Source: EIU, 2004

It is expected that the huge Camisea natural gas project and mining and export of minerals, textiles and agricultural products will be the significant contributors to the economy. The Camisea project is estimated to add a percentage point to the GDP growth per year, along with substantial tax revenue and cheaper, cleaner fuel for domestic and industrial power production. Continued investment in the mining sector, and the high prices of copper and gold should sustain the current trends. The recent Andean Trade Promotion and Drug Eradication Act that provides free access to US markets for about 6000 items is also seen as useful in textile and agriculture exports.

Due to its substantial dependence on minerals, Peru is more vulnerable to potential downward pressure on mineral prices “in the event of a more rapid than forecast slowdown in growth in China.” Similarly, as an oil-importing country it is sensitive to oil price changes (EIU). Non traditional exports are expected to continue their steady performance, with cotton and wool garments doing particularly well. Growth in manufacturing had been wide based, but agricultural droughts affect this sector adversely.

A large part of the FDI has been via the privatization program. The privatization of the mining opened the doors to foreign firms. The Lam Bambas mining concession attracted a record bid. It is likely that Mr. Toledo will focus the rest of his tenure on the power sector. Recent tax increases should allow the government to responsibly increase expenditure in 2005-06. This is in view of the commitment to increase teacher’s salaries and security spending.

### *Social Climate*<sup>6</sup>

Peru is a lower middle-income country, with a per capita income of \$2150 (by the Atlas Method, 2003) and has 49 percent of its population below the national poverty line. According to the UNDP, in 1990-2001, it had 41.4 percent of the population living below \$2 per day of which 15.5 percent lived on less than \$1 per day<sup>7</sup> (Annex). Peru ranks 85 (of 177 countries) on the Human Development Index, has a relatively high literacy rate of

<sup>6</sup> World Bank, **Peru Country Assistance Strategy 2002-2006; Governance in Peru:**  
[http://www.worldbank.org/wbi/governance/peru/pdf/peru\\_voicesreport.pdf](http://www.worldbank.org/wbi/governance/peru/pdf/peru_voicesreport.pdf) **and data**  
[http://www.worldbank.org/wbi/governance/peru/pdf/peru\\_summary\\_xtables.pdf](http://www.worldbank.org/wbi/governance/peru/pdf/peru_summary_xtables.pdf)

<sup>7</sup> Human Development Report, UNDP, 2003. Here “\$1 a day—at 1985 international prices (equivalent to \$1.08 at 1993 international prices) is adjusted for purchasing power parity. And \$2 a day—at 1985 international prices (equivalent to \$2.15 at 1993 international prices) is adjusted for purchasing power parity.

85 percent among those above 15 years of age (youth literacy for those between 15-24 years is 96.6 percent).

<b>Select Social Indicators for Peru</b>			
	<b>2003</b>	<b>2001</b>	<b>1999</b>
<b>Population<sup>a</sup></b>			
Population, total (thousands)	27.148	26,347	25,939
Rural population (% total population)	n/a	26.87%	27.23%
Population density, rural (people per sq km)	n/a	n/a	191
<b>Poverty and Inequality<sup>b</sup></b>			
% Population under \$2 a day PPP <sup>d</sup>	n/a	41.4%	n/a
Poverty gap at \$2 a day (%)	n/a	n/a	14.62
% Population under \$1 a day PPP <sup>d</sup>	n/a	15.5%	n/a
Poverty gap at \$1 a day (%)	n/a	n/a	5.39%
GINI index	n/a	.498	n/a
<b>Employment</b>			
Economically active population <sup>c</sup> (% of population over 15 years of age)	65%	68.8%	68.2%
Unemployment, total <sup>c</sup>	385,999	651,489	624,948

Source: <sup>a</sup> The MIX Market: <http://www.mixmarket.org/>

<sup>b</sup> The World Bank Group

<sup>c</sup> LABORSTA Internet: <http://laborsta.ilo.org/>

<sup>d</sup> Human Development Report 2004, UNDP

Peru's population is concentrated in urban areas, with 73.5 percent in urban areas in 2002 and a projected 78 percent in urban areas by 2015<sup>8</sup>.

The World Bank indicates that poverty reduction programs as well as social expenditure are limited because of Peru's lack of public resources (and are a reflection of the country's low and declining tax effort).

Sixty per cent of Peru's urban workforce is employed within the small and micro enterprises (SMEs) which account for 95 per cent of all business in the country's manufacturing, commercial, and service sectors. But in spite of credit needs of some US\$ 1,250 million, in 1994 the combined input from the formal financial sector, international development agencies, and NGOs met only 5 per cent of this demand<sup>9</sup>.

<sup>8</sup> Ibid.

<sup>9</sup> <http://poverty.worldbank.org/library/view/10257>

## Peru: GDP, According to Market Share of Enterprises, 2001

Segment	GDP (Est) %
<b>Private Sector</b>	<b>74</b>
Large Enterprises (200 and more)	29
Medium Enterprises(50-199)	17
Small Enterprises (10-49)	10
Micro Enterprises (2-9)	18
<b>Self-Employed</b>	<b>19</b>
Independent:qualified	2
Independent: urban not qualified	11
Peasantry:minifarms	6
<b>Households</b>	<b>1</b>
<b>Public Sector</b>	<b>6</b>
<b>Total</b>	<b>100</b>

Source: III Forum for development and poverty reduction, 2001  
Elaboration: SASE

## II. Overview of the Microfinance Sector

The microfinance sector in Peru represents about 5% of the total financial sector, but during the last ten years average annual rates of growth of the loan portfolios of MFIs has been 32.3% (SBS). While microfinance remains a small percentage of the total financial sector, the picture is altered if the focus on the number of clients rather than portfolio size, and it is estimated that MFIs have 30-40% of the borrowers in the financial system.

The majority of the approximately 55 non-bank MFIs operating in Peru are regulated. In terms of portfolio size, the vast majority of the sector is regulated as the non-regulated MFIs tend to have relatively small portfolios. MFIs vary greatly in quality and size. As one commentator remarked, the sector has “both ants and elephants”.

Most of credit provided by the MF sector is directed towards micro-enterprises as opposed to consumer credit. Mortgage lending is an increasing area of focus for many MFIs. By economic sector, most of the microenterprises tend to operate in the retail sector in urban areas. Rural microfinance is considered both unprofitable and highly risky, as a result only 3.2% of formal MFI lending is for agricultural and livestock credits.

### *Policy support for MF sector*<sup>10</sup>

In general policy support for the MF sector is high, with a legislative framework that specifically targets MFIs in place. The regulatory framework will soon allow all regulated MFIs to take deposits, does not place any restrictions on interest rates charged,

<sup>10</sup> [http://www.cgap.org/regsup/docs/pro\\_Peru.pdf](http://www.cgap.org/regsup/docs/pro_Peru.pdf)

and does not hinder foreign investment. For a more detailed discussion of the regulation of the MF sector please see Section III.

### *Composition of the sector*

The regulated sector consists of commercial banks with microfinance operations, thirteen municipal savings banks (Cajas Municipales de Ahorro y Credito [CMACs], twelve rural savings banks (Cajas Rurale de Ahorro y Credito [CRACs]) and fourteen regulated NGOs (EDPYMEs [Small Business and Microenterprise Development Institution]). The SBS estimates that non-bank formal MFIs have about 1.5 million clients and direct loans of \$684 million in 2003. Regulated institutions have to comply with auditing and reporting requirements stipulated by the supervisory body SBS, conduct strict loan loss provisioning, and report to the SBS on a monthly basis.

Strict SBS supervision has had an effect on portfolio quality as delinquency rates for regulated non-bank formal MFIs have fallen from greater than 10% in December 2000 to 5.7% by the end of 2003 while loan loss provisioning currently covers 130% of portfolio at risk. Formal MFIs have in general been profitable, showing ROEs in excess of 15% with the exception of the crisis in 1997/1998 when ROE plunged to 5% (SBS).

Of the non-bank formal MFIs the CMACs are the largest and most profitable institutions while the EDPYMEs, most of which have only recently converted from NGOs to for profit institutions, tend to be smaller and show lower returns. The profitability and growth of CMACs is partially driven by their ability to take deposits, which currently account for over 70% of the sources of finance for many CMACs. At year-end 2003 CMACS had total deposits of \$357.5 million while CRACS had deposits of \$84.6 million (CMAC Arequipa, 2003). Several EDPYMEs indicated that their inability to take deposits made it very difficult for them to compete with the CMACs. Within particular agency-types, there are of course large variances in the quality of specific institutions. For example some CRACs are of the same quality as CMACs whereas others have low profitability. Similarly among the EDPYMEs, Confianza and Edyficar have been growing more steadily than their cohort members. The stronger EDPYMEs have shown ROEs between 4-6% while delivering substantial social returns.

The commercial banks are relative newcomers to the sector, but have rapidly built up substantial microfinance portfolios. Two of the leading commercial banks involved in microfinance activity in Peru are Mi Banco and Banco de Trabajo. Between them these two banks have 344,054 active borrowers and a total portfolio size of \$312.1 million. This is almost the size of the combined portfolio of the thirteen CMACs and demonstrates the potential that these institutions have to impact the future of the sector. Indeed, as is discussed further in Section VI, the entry of commercial banks into microfinance may be a threat to the sustainability of non-bank MFIs. Thus far the commercial banks' microfinance portfolios have been highly profitable showing ROEs in excess of 25%.

## Semi-Formal MFIs

Unregulated MFIs can voluntarily share their financial information with COPEME (Consortium of Private Organizations that Promotes the Development of Small and Medium Enterprises), an institution that was created in 1990 to promote and execute programs, projects and activities related to the development of small and medium enterprises at the regional and national level. COPEME's goal is for the NGOs that report to it to meet the same financial tracking and disclosure standards as formal institutions, albeit only reporting every three months as compared to monthly. It is generally acknowledged that while the self-regulatory body of COPEME is better than no regulation at all for the informal MFIs, its voluntary regulation is less effective than that of the SBS. This can be seen in loan loss provisioning practices, where although some organizations have loan loss provisioning greater than 100% of their portfolio at risk, many NGOs do not and some appear not to conduct any loan loss provisioning at all.

Approximately sixteen NGOs with unregulated microfinance programs currently report to COPEME. COPEME estimates that as of March 2004 these institutions had 104,630 outstanding loans and a total portfolio size of approximately \$17 million. In terms of operational sustainability, of the eight NGOs that reported this information to COPEME, six are sustainable. The eight institutions which did not report this information may be unable to track this information or do not wish to share it. Portfolio quality varies substantially between NGOs, with many NGOs reporting portfolios at risk of less than 5% while other NGOs have over 25% of their portfolio at risk. COPEME estimates that of the 16 NGOs it works with, six to seven of the NGOs that it works with are of similar institutional quality as the EDPYMEs.

## *MFI Rates*

Interest rates were liberalized during the 1990s. Because of the perceived lower riskiness of holding dollars as compared to soles, there is a significant spread between the dollar and sole rates charged on microenterprise loans, consumer credit, and savings deposits. As can be seen in the table below, on the microlending side, the CMACs and the CRACs charge broadly similar rates on microenterprise and consumer credit and pay similar rates on savings deposits. The EDPYMEs charge generally higher interest rates – perhaps a result of their inability to take advantage of economies of scale due to their small portfolio size.

### Interest Rate By Institution Type and Type of Financial Activity

Institution Type	Microenterprise Loan of <365 Days		Consumer Credit of <365 Days		Savings Deposits from 181 – 365 Days	
	Soles	Dollars	Soles	Dollars	Soles	Dollars
CMAC	57.29%	31.19%	45.50 %	26.18%	11.47%	4.09%
CRAC	53.00%	24.87%	39.48%	21.69%	11.72%	4.91%
EDPYME	63.43%	31.88%	65.29%	60.89%	N/A	N/A

Source: SBS (October 2004 Rates)

The market's perceived riskiness of the microfinance sector can be seen from the spreads between MF rates and commercial lending rates. Currently, the commercial bank lending rate is 14.2% while the commercial bank deposit rate is 3.8% (The Mix, 2004).

### ***Sustainability***

The majority of formal MFIs operating in Peru are sustainable. As discussed above, formal sector MFIs have on average shown a healthy ROE of approximately 15% during the past few years. The CMACs and the CRACs, because of their abilities to mobilize savings deposits, are largely able to finance their operations through internal resources. For example 89.3% of CMAC Arequipa's sources of finance are internal (73.2% from deposits and 16.1% from retained earnings)<sup>11</sup>. As a result many of the CMACs are not currently seeking external financing.

### **Glance at Financial Performance Standards (FPS)**

	Commercial Banks <sup>1/</sup>		CMACs		CRACs		EDYPMEs	
	2002	2004	2002	2004	2002	2004	2002	2004
<b>Solvency</b>								
Global Leverage (no. of times)	7.81	7.11	5.29	6	5.62	6.04	2.16	2.33
<b>Portfolio Quality</b>								
Portfolio in arrears/Direct credits (%)	8.02	5.1	5.61	5.37	12.41	9.55	9.23	11.89
Provisions/Portfolio in arrears (%)	124.87	146.87	133.27	128.69	111.62	124.87	93.52	85.88
High risk portfolio/Direct credits (%)			7.86	7.01	31.14	21.15	11.81	13.51
<b>Liquidity</b>								
Loans/Total Liabilities (%)			15.73	16.66	40.02	24.61	92.34	92.53
<b>Efficiency and Management</b>								
Administrative expenses/Direct and Indirect credits (%)			13.22	11.12	14.07	12.64	17.08	18.33
Direct credits/Staff (thousands of soles)	1990	1754	624	834	682	621	371	374

<sup>1/</sup> Includes offices abroad

As is discussed further in Section VI there is some concern among MFIs that increased competition may put pressure on the sustainability of the weaker institutions.

### ***Outreach***

The uniqueness of MFIs is that they are able to reach segments of the population which the formal financial sector does not serve. In Peru, the success of microfinance has provided access to new capital to approximately 1.5 million clients, the majority of whom previously did not have access to finance. On the other hand, most MFIs clarified that they could not make reaching out to most vulnerable populations, with historically low access to finance, the focus of their operations. Therefore, as mentioned previously, the MFI initiative is generally restricted to Peru's larger cities.

<sup>11</sup> - CMAC Arequipa 2003 Annual Report.

Based on data provided to the MIX and COPEME it can be seen that the average size of microfinance loans by formal MFIs is between approximately \$800 and \$950, which is about 40% of the Peruvian GDP per capita of \$2150 (using the Atlas Method). There is however, substantial variation in the sizes of the average loans of the institutions that make up each category. Non-regulated MFIs appear to reach out more vulnerable populations with average loan sizes of \$252 or 11.7% of GDP per capita.

### Loan Size By Institution

Institution Type	Number of Institutions Providing Information	Average Loan <sup>12</sup>	Range in Average Loan Sizes among Institutions	Average Loan as % of per capita GDP
Commercial Bank	1 (Mi Banco)	\$931	N/A	43.3%
CMAC	10	\$879	\$366 - \$1,082	40.9%
EDPYME	8	\$812	\$581 - \$1105	37.8%
NGO	16	\$252	\$77 - \$1,080	11.7%

Sources: The MIX, COPEME.

In the regulated sector, institutions like Mi Banco have to report on some social indicators as a part of their general requirements, for example they report that 57% of their clients are women. On the other hand, the CMACs did not find the “need to differentiate” amongst their clients and generally do not track information such as the number of women borrowers or the number of their borrowers living on less than \$2 per day.

In the unregulated sector, PRISMA is one of the rare cases that has ventured into rural areas and lent to the poorest, though their enterprise is made possible by USAID assistance. FINCA Peru on the other hand has a faithful base of 6000 clients that it has nurtured since 1998, it does not lay premium on increasing this base. While FINCA does not lend to the poorest of the poor, as it wants its clients to be economically active so that they can put their loans to productive use, it has resisted formalization because it worries that becoming a regulated institution would lead to mission drift.

The concern however is that within the current MFI sector there is a scramble by the various institutions to attract clients who are already within the system. This has created a problem of over-indebtedness of clients which is unsustainable and potentially harmful to the socio-economic security of these individual borrowers.

### III. Regulatory framework

The Superintendencia de Banca y Seguros (SBS) is the public agency that regulates formal MFIs. The regulatory framework for MFIs is very similar to that of commercial banks. Both types of institutions are regulated under the same financial law. For example, MFIs are required to report financial information similar to the information commercial

<sup>12</sup> - Weighted for institutions’ portfolio sizes.

banks must report (information on loan portfolio quality, interest rate risk, foreign exchange risk, etc.)<sup>13</sup>. SBS also requires MFIs to do their own internal auditing as well as receive external auditors at least once a year.

The financial services that each type of MFI can allow are different. EDPYMES are only permitted to offer credit. These institutions can obtain resources from bank credit, equity markets, and COFIDE refinance. With prior approval of SBS and with a capital base of \$1.4 million, these institutions can take public deposits. CMACs are permitted to offer savings services, and pension and current accounts (no checking), personal and business loans, bill payments, and forex operations. These institutions cannot offer savings services nor pawn loans before their first year and cannot offer micro enterprise loans before the third year. CRACs can offer passbook savings services and term deposits (they cannot offer current accounts). Commercial microfinance banks can offer full financial services. The minimum capital to start a commercial microfinance bank is \$5.3 million. For EDPYMES, CMAC, and CRACs, the amount is \$241,000. On the other hand, MFIs with ratings below B require SBS authorization to open new branches.

The following table summarizes the regulatory framework with respect to licensing, capital reserves, guidelines on business activities, and reporting and supervision requirements. The information of the table applies to the four types of regulated MFIs.

<b>Organizational Registration</b>	
Costs of Registration (money and time)	There is no registration fee, but the process takes at least a year and requires extensive documentation. (Resolution SBS 600-98)
<b>Licensing Requirements and Standards</b>	
Feasibility study/Business plan	Feasibility study, market survey in proposed area of operation, and three year's financial projections required.
Permitted sources of funds	No restrictions on the currency or the lender (except in special circumstances)
<b>Capital and Reserves</b>	
Minimum capital adequacy/gearing ratios	Max ratio of liabilities to net equity = 10:1; risk-weighted assets cannot exceed 11 times regulatory capital.
Loan loss provisioning, write-off	Specifically for microcredit: 1-8 days past due: 1%, 9-30 days: 5%, 31-60 days: 25%, 61-120 days: 60%, 120 days or more: 100% (with specific collaterals, provision rates are lower).
<b>Guidelines &amp; restrictions on business activities</b>	
Operational rules, restrictions	SBS authorization needed to open branches except when the MFI has a rating of B or higher.
Interest rate restrictions	None
<b>Reporting &amp; Supervision</b>	
Supervision method	Regular annual, and special, on-site inspections
Disclosure and reporting requirements	Monthly remissions of financial statements, reports of loan portfolio quality, interest rate risk, foreign exchange risk, etc. (based on the permitted operations).
Depositor Protection mechanisms (e.g. deposit insurance or lender of	Deposit Insurance Fund which covers deposits from the public up to US\$20000

Source: IRIS (2003), Available at <http://www.iris.umd.edu/>

<sup>13</sup> See statistics <http://www.sbs.gob.pe/PortalSBS/Estadistica/index.htm>

It's noteworthy to mention the high quality of the regulatory body in Peru. During our fieldwork, most MFI managers and analysts pointed out the high professionalism of SBS staff.

### ***Proposed reforms***

Until October 2004, article 290 of the Ley General del Sistema Financiero was inflexible with the financial activities an MFI could undertake. In order for an MFI to increase its financial services, the law asked the institution to change into another module. This made the growth and the transition of an MFI more difficult in two ways. First, the MFI had to offer the complete array of financial services of its new status. Second, the MFI had to completely meet a set of requirements to change to another module. The amendment, likely to pass in November 2004, will make the transition easier. The amendment will allow all MFIs to increase their financial services without forcing them to change their legal status or require them to meet all requirements (Legislative Decree 11312/2004-PE).

The amendment is likely to increase the size of existing MFIs. For example, it will allow EDPYMEs to collect savings from the public, the major financing source of the other MFIs. This will help EDPYMEs to grow and become more competitive. The reform will also encourage MFIs to increase the supply of financial products in their respective markets.

In recent years COPEME has worked with many of the NGOs that successfully converted to EDPYMEs. Incentives were provided for this conversion by the government as while all MFIs must pay a tax of 30% on their profits, non-regulated MFIs must also charge VAT of 19% on their interest rates. At this point in time all of the large NGOs, with the exception of PRISMA, have converted or are in the process of converting to EDPYMEs. As the process is very costly and time consuming it is not likely that there will be many additional conversions.

## **IV. Incentives and Disincentives for Information Sharing**

SBS requires regulated MFIs to provide monthly financial statements, reports of loan portfolio quality, interest rate risk, foreign exchange risk, etc in accordance with international accounting standards. COPEME also has a database covering unregulated institutions in Peru. With the approval of the individual MFIs, it makes its information available to donors and other sources of finance. Aggregated data are published for four groups of MFIs, three which are unsupervised and differentiated by lending methodology (individual, group, community banks), and the fourth consisting of regulated institutions. COPEME substantially adjusts the information provided by the MFIs in accordance with SBS's norms on the basis of international accounting standards and the imputation of a market cost of funds.

Infocorp is the principle credit bureau that collects and supplies information on the Peruvian commercial financial sector. It started collecting information on the microfinance sector three years ago in response to government initiatives to encourage greater availability of information about this sector. It currently has information on 750,000 borrowers in its database and 1,700 clients ranging from banks, telecommunications companies and private enterprises. It estimates it has coverage of 80% of regulated MFIs and 90% of non-regulated MFIs.

Infocorp signed an agreement with COPEME in 1998 that enables the two agencies to share data on non-regulated MFIs with their consent. Currently, more than 80 MFIs are registered with COPEME to use the Infocorp database, of which 34 are NGOs with financial operations. Of those, 20 are already providing the Infocorp database with their negative information on a systematic basis.

Despite these efforts, lack of information remains a major problem in the Peruvian microfinance sector. While information about borrowers who are overindebted is hard to obtain, lack of information about good clients or potential clients is even more scarce, acting as an impediment for outreach to poorer but financially responsible clients.

### *Disincentives*

#### *Perception of trade-offs*

Lack of information is a larger problem in the informal sector than the formal sector as most MFIs in the informal sector perceive a trade-off between sharing information about their financial situation and retaining the flexibility and autonomy to conduct outreach activities and service the very poor.

#### *Lack of enforcement capacity*

The difference in institutional capacity between COPEME and SBS also acts as a disincentive for informal MFIs to provide information. COPEME unlike SBS lacks the capacity to conduct on-site inspections and is unable to levy penalties for bad financial management. Only 16 NGOs report to COPEME whereas 39 report to SBS.

#### *Competition between MFIs*

Competition amongst MFIs in the same client markets also acts as a barrier to sharing information. Felipe Portocarrero [INSERT credentials] recommended the adoption of Bolivia-style guidelines by MFIs regarding information sharing to minimize this problem. One incentive problem with sharing client information among MFIs is such a practice might lead to an increase in portfolio at risk at MFIs – making their financials look more unattractive in the short run. For example, if the guidelines required you to consider a client who was on-time at your institution to be at risk because he was late at another institution this would lead to deterioration in your portfolio quality.

### *Lack of institutional capacity*

In smaller MFIs, lack of adequate information systems and bad governance structures also acts as an impediment to collecting requisite information, particularly about the level of indebtedness of clients who borrow simultaneously from multiple organizations. There are also substantial time lags of up to six weeks in the provision of client information to SBS and its dissemination to credit bureaus such as Infocorp. COFIDE highlighted the need for more investment in improving management and technology systems in MFIs. Inadequacies in these areas affects the quality as well as the quantity of information supplied. Certain commentators said that SBS could improve information quality by modifying the indicators on its financial reporting template. In the informal sector the high cost of upgrading management of information systems is a significant hurdle. For example Caritas received \$5m from USAID to assist it in upgrading its MIS systems and restructuring to prepare for its conversion to a formal MFI.

### *No obvious benefits*

Some MFIs interviewed said that they often did not see immediate benefits in providing information since the agencies they reported to did not actively try to locate additional donors for them on the basis of this information.

### *Incentives*

Despite its shortcomings, Peru is still ahead of Guatemala, Ecuador, Honduras and Bolivia in the amount of information it does have about the microfinance sector. This has also been facilitated by the provision of technical assistance to MFIs and government efforts to formalise the informal sector.

### *Provision of technical assistance*

COPEME provides technical assistance in return for the regular provision of financial information from MFIs. It organizes technology fairs during which it runs workshops for MFIs on improving information quality and auditing practices. Additionally donor agencies sometimes try to facilitate financial reporting. For example, PRISMA's major donor, USAID pays for its audits. In the formal sector foreign donors such as Germany have provided technical assistance to the CMACs to improve their management and information systems.

### *Formalisation of the informal sector*

Agencies such as COFOPRI (the *Comisión de Formalización de la Propiedad Informal*) have, since 1996 been involved in compiling a formal registry of informal urban property know as the *Registro Predial Urbano* (Urban Real Estate Registry). While this is a step towards improving the quality of client-information available, as yet no formal database-sharing arrangements exist between COFOPRI and information bureaus such as InfoCorp.

### *Means of attracting capital*

Some MFIs interviewed do see the provision of information as a means of attracting foreign investment, especially EDPYMEs and NGOs. Given that EDPYMEs cannot collect savings, these institutions rely more on foreign capital. Currently, EDYFICAR seeks fresh capital not only to increase its financial operations, but also to diversify its investment sources. The outreach of NGOs such as PRISMA is usually to poorer segments of the population. Compared to other MFIs, the operations of PRISMA and similar organizations have a higher risk. Thus, the operations are less likely to be funded by savings. However, PRISMA and other NGOs continue attracting foreign capital from international organizations and social responsible investors because of their greater social impact.

### *Information Provision for Internal Use*

As in any company, the management of MFIs can be improved by having better information about the performance of their different areas. For example, management can analyze how the share of operational costs has changed across time in the organization. Management can also measure the performance of this indicator to a benchmark of similar organizations. This allows MFIs to detect areas where improvement can be done. EDYFICAR has an important dataset of performance indicators, qualitative and quantitative, that has helped it make 10-year strategy plans with a higher degree of certainty.

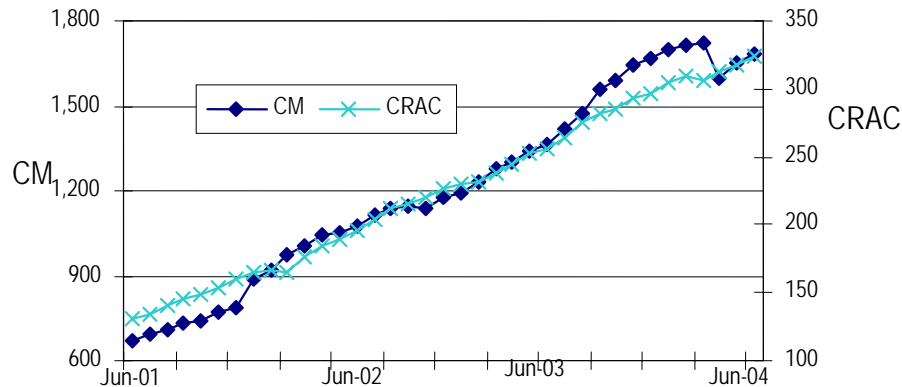
## **V. Investment climate**

### *The Demand-Supply Gap in the Provision of Microfinance Services*

Despite the great growth of the assets and the loan portfolio of the MFIs during the last decade, (both grew more than 10 times), the demand for foreign capital by MFIs has remained relatively constant. MFIs have found their main financing source from mobilizing their deposits. Given that great part of the population has a low savings capacity, great part of them can only save through MFIs. In addition, the CMACs, which hold 80.1% of the deposits of the MFIs, are required by law to capitalize 50% of their profits. This source of financing is particularly important given the high profits of CMACs.

By the end of June 2004, the total deposits in MFIs represented 2,004 million soles. With respect to June 2003, the total deposits increased by 23.4%. This high rate continued the trend of past years and shows the high potential that domestic capital still has.

### Deposits (in millions of new soles)



COFIDE, a second floor bank, is another source of domestic capital. In 2003, this bank approved loans of \$12.4 million dollars to CRACs, \$32.8 to CMACs, and \$20.8 to EDYPMES. These loans represented 16.1% of the approved loans of COFIDE for that year.

The greater deposit rates increased the credits granted by MFIs. From June 2003 to June 2004, the CMACs increased their direct loans by 34.9%. The EDPYMEs and CRACs increased their loans by 25% and 27.5% respectively. Relative to other financial institutions, MFIs allocate a greater part of their loan portfolio to micro enterprises. By June 2004, loans to micro enterprises represented 1,361 million soles or 52.2% of the portfolio of MFIs.

With respect to economic sectors, credits to commerce concentrate 60.6% of the commercial and micro enterprise credits. Credits to this sector grew 35.5% during the last year. For CMAC, credits to commerce increased by 37.4%. For EDYMEs, 45% of their portfolio increase was directed to this sector. The high profitability of this sector helps explain its importance in MFI loan portfolio and therefore the high rates that MFIs offer to savers. Even though the amount credits to the primary and the manufacture sector increased, their participation on the MFI portfolio decreased during the last year. Rural micro finance is considered both unprofitable and highly risky, as a result only 3.2% of formal MFI lending is for agricultural and livestock activities.

Commercial banks are rapidly entering into the microfinance industry. As it can be seen in the table, between October 2002 and October 2004, commercial banks increased their outstanding loans to micro enterprises by 81.0%. During this period, Banco del Credito del Peru increased its loans by 313.9% and Banco del Trabajo by 58.6%. These banks are now first and second respectively with respect to the amount of micro enterprise loans.

**Outstanding Direct Credits**  
(thousand of soles)

	Credits to Microenterprises			02-04 change
	2002 <sup>1/</sup>	2003 <sup>1/</sup>	2004 <sup>1/</sup>	
B. Continental	110,067	98,027	40,946	-62.8%
B. de Comercio	760	137	223	-70.7%
B. de Crédito del Perú (includes abroad offices)	117,069	195,489	484,493	313.9%
B. del Trabajo	208,808	277,677	331,247	58.6%
B. Interamericano de Finanzas	489	1,923	6,389	1206.5%
B. Sudamericano (con sucursales en el exterior)	946	875	38,217	3939.9%
B. Wiese Sudameris	77,481	82,140	105,940	36.7%
Interbank	0	0	4,747	
Mibanco	185,670	242,729	254,357	37.0%
Others	4,117	1,545	10,538	156.0%
<b>TOTAL COMMERCIAL BANKS</b>	<b>705,407</b>	<b>900,542</b>	<b>1,277,097</b>	<b>81.0%</b>

1/ October of each year

Source: SBS

***Opportunities for Investors***

The regulatory structure encourages foreign investment mainly in two ways. First, the regulatory framework is friendly to foreign investment. There are no restraints to ownership or possession by foreign investors. Foreign investors are subject to the same conditions applicable to a national. Acquisition of national investors' shares is fully allowed through stock exchange or other mechanisms. Second, regulatory rules against fraud are strict and to a great extent followed. Each MFI must be audited at least once a year. If the SBS detects fraudulent operations, by law, it must press criminal charges against those responsible (see regulatory framework table for further information).

The demand for foreign capital can potentially be greater. First, the micro credit market is far from being saturated. It is estimated that MFIs have only focused on 30% of the potential market. The remaining portion of the market is more difficult to serve because it is poorer and therefore needs smaller loans (which increase transactions costs). To serve the remaining market in a sustainable way MFIs need additional capital to obtain economies of scale. Given the size and the greater focus on social impact, this additional capital may be provided socially responsible investors. EDYFICAR presents an example. This EDPYME received an initial capital loan of \$500,000 dollars from CARE. This large loan helped EDYFICAR lend to poorer segments. Contrary to most CMACs, EDYFICAR today faces little competition in its market and the institution is profitable.

Second, given the rapid entry of commercial banks into the microfinance industry and their greater access to foreign capital markets, it is likely that the demand for foreign resources from this industry will increase. Last year, MiBanco was the first Peruvian MFI to issue its own bonds. It is likely that MiBanco will continue issuing bonds and that

other MFIs will explore this alternate method of raising debt. Third, as mentioned in the regulatory framework section, the amendment to art. 290 of the Financial Law is likely to increase the level of operations of MFIs and their number.

Finally, a risk index imposed by SBS to MFIs may be adjusted during the next year. The index, applied to all financial institutions, requires MFIs to only receive investment with a similar payment period to the allocations of their own loan portfolio. For example, if the additional credits an MFI grants rotate in average once a year, the MFI can only have access to one-year investments. The problem is that MFIs usually can rotate their portfolio faster than the conditions which would be optimal for the investor. There is a possibility that this risk index may be adjusted for MFIs in the near future.

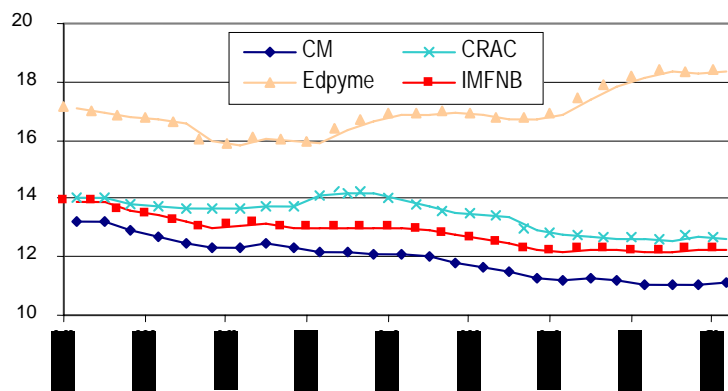
### **Transaction Costs**

The transaction costs will always be higher for micro loans than for commercial loans. The lack of client information, the smaller size of loans, the fragmentation of supply, and other variables increase the transaction costs. The MF industry in Peru has a relative disadvantage with Bolivia, for instance, in the sense that Peru’s industry is highly fragmented. There are many more MFIs in Peru than they are in Bolivia. Thus, the industry does not take advantage of greater economies of scale.

Peru has an advantage over most Latin American countries with respect to information infrastructure. Over 90% of the micro finance operations of Peru are registered and reported to SBS. Interest rates and fees of all MFIs are widely spread by the SBS. In addition to this, if a person is interested in more precise information of a client, he or she can purchase at reasonable price information from private credit bureaus such as Infocorp. For example, a person who wants to sell his house can know how much debt the potential buyer and the buyer’s credit history by paying \$7. According to Infocorp, Peru has one of the most developed credit bureaus industries of the developing world.

Transaction costs also tend to decrease with time. Given that the microfinance industry in Peru is among the oldest in Latin America, the efficiency indicators are relatively low. By June 2004, the ratio of administrative expenses to direct and indirect credits for CMACs was 11.1% and for CRACs was 12.6%. In the case of EDPYMES, the ratio is 18.3%. Nonetheless, the ratio for the entire industry has declined for the last two years (SBS).

**Administrative Expenses / Direct and Indirect Credits**



### ***Ease of Investing and Pulling Out Money***

Foreign investment receives no different treatment than national investment. Foreign investment can be undertaken without previous authorization from the government. However, once the investment has been done, it has to be reported to Comisión Nacional de Inversiones y Tecnologías Extranjeras (Conite).

There is no restriction to repatriation of capital. Foreign investors are guaranteed the right to remit in freely convertible currency, without requiring beforehand an authorization from the government, after paying the taxes required by law, the full amount of their capital (art. 7 Legislative Decree 662). When withdrawing their money, foreign investors in micro finance must follow the same procedures that commercial investors do. It is noteworthy to mention that a financial crisis in the industry is unlikely since the government guarantees all deposits in the financial system below \$20,000 dollars. This practically covers all MFI clients.

### ***Management and Portfolio Structure Issues***

Some analysts pointed out that CMACs have avoided to take outside capital, either domestic or foreign, because their managers feel they would lose control of their institutions and somehow “status”. In addition, managers may also not have economic incentives. The high profits of the CMACs reduce the incentive to invite further shareholders. An interviewed MFI pointed out that some socially responsible investors that offer grants to NGOs usually do not want the grant to be used in microfinance activities. Socially responsible investors frequently have their own agenda and ask NGOs to do a specific task.

On the other hand, other interview respondents noted that donors often do not provide the same level of management oversight and input into strategic thinking and decision making as do commercial investors who have a much stronger motivation to ensure that their money is being utilized effectively. As a result those institutions that rely primarily on donor finance can sometimes suffer from a lack of a coherent strategy.

## **VI. Risk Factors to Microfinance**

### ***Political***

The populist tendencies of recent governments present a potential risk to MFIs although this risk should be considered lower than that present in other Latin American countries. In the past politicians have provided indebted clients with cash transfers in the lead-up to elections in order to woo their votes. This has then had a contagion effect on other borrowers and greatly increased default rates. One MFI in particular highlighted the damage done by a government bail-out of rural farmers in 1998. At that time the government offered a politically motivated rescue plan to farmers despite the fact that

only 5% of the MFI's agricultural portfolio was not making payments on time. Once those farmers who were paying on time saw this bail-out they also stopped making payments on their loans. The MFI ended up losing almost its entire agricultural portfolio and as a result no longer lends to the agricultural sector. One current example of populist political risk is the government's *Mi Vivienda* mortgage program. As a number of MFI's are affiliated with this program this is an area of concern that bears watching.

### ***Economic***<sup>14</sup>

Although GDP growth in Peru was a strong 4% in 2003 the economy was in a depressed state from 1998-2001 and this was reflected in falling employment rates and low growth during this period (an average of 1.7% per year from 1998-2002). The economy started a solid recovery in mid-2002, but unemployment and underemployment remained stubbornly high in the first half of 2004. The Economist Intelligence Unit predicts extremely strong 4.9% growth in 2004 followed by 4.2% growth in 2005. However, as primary products represent the bulk of Peru's economy the country is highly susceptible to commodity price and ecological shocks – as was demonstrated by the slowdown in the economy following the 1998 occurrence of the El Niño weather effect. Nevertheless, barring unforeseen shocks, the economic outlook for the next two years appears strong.

Inflation has been low in Peru for several years, with a consumer price inflation of 2.3% in 2003 and a stable price outlook for 2004. Inflation is therefore not a current source of risk for MFIs. Peru did experience a period of hyperinflation during the early 1990s so this is concern cannot be completely ruled out.

### ***Financial***<sup>15</sup>

Following the liberalisation of the economy in the 1990s, a trade deficit opened up and widened rapidly to 4% of GDP in 1995 as investment, a strong currency, and a consumer boom attracted imports. The government's response was a sharp tightening of fiscal and monetary policy, which succeeded in slowing import growth sufficiently to narrow the deficit. In 2002, boosted by export earnings from Antamina, Peru recorded its first trade surplus since 1990. The trade surplus widened in 2003, to 1.2% of GDP, on the back of continued strong growth in mining exports, supported by rising commodities prices.

According to the World Bank, Peru's external debt totalled US\$27.5 billion at end-2001. Of the total debt, 11% was short-term debt, down from 22.4% at end-1997. This was a result of the efforts of commercial banks in Peru to restructure their balance sheets, as well as to the government replacing short-term debt with cheaper long-term debt.

Foreign reserves recovered in the 1990s after collapsing in 1987-88. Reserve requirements of the banking sector form a large part of the total: banks have to place 30% of US dollar deposits with the Banco Central de Reserva del Peru (BCRP, the Central

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<sup>14</sup> - Economist Intelligence Unit, Peru Country Profile 2004.

<sup>15</sup> - Ibid.

Bank). By the end of 2003 reserves were US\$10.2 billion, sufficient to cover 11.4 months of imports.

### ***Currency***

The Peruvian Nuevo Sol is currently floating freely against the dollar at a rate of 3.40. The last major revaluation of the Sol was in 1998 and since 2000, despite political uncertainty; it has traded between 3.40 and 3.62. Peruvian MFIs prefer to make loans in Soles as they are able to charge an interest rate of 70-80% on loans in Soles as compared to 35-40% for loans in dollars (COFIDE). As long as currency stability is maintained this practice is not risky. Some MFIs, such as Finca Peru, avoid this potential risk by only lending in dollars. Other prudent MFIs that receive dollar financing for their portfolios deposit the dollars that they receive in commercial banks as a guarantee against a loan in local currency for the same amount. They then use the local funds to expand their portfolio so that both their income and their financing repayments are in soles. It does appear however, that whatever currency risk that exists is being almost entirely borne by MFIs as opposed to by donors or investors.

### ***Geographical Concentration***

Competition in the MFI sector in Peru is vigorous with 39 formal sector institutions and 16 unregulated NGOs being active in the MF sector. The majority of these institutions focus on lending in urban environments and thus are increasingly competing directly with each other. COPEME estimates that only 25-30% of Peruvians have access to credit and that the remaining 70% of the market is very difficult to serve. As a result many of the MFIs are targeting the same group of clients. As the MF market becomes more saturated MFIs will be less able to rely on geographic niches to survive as they have in the past. Successful institutions such as CMAC Arequipa are only now for the first time experiencing large scale competition on their home turf as Mi Banco, Banco de Trabajo, Edyficar and Pro Empresa have recently started operations in Arequipa. To the extent that this competition forces a reduction in interest rates, some of the weaker institutions may face bankruptcy, be acquired, or be forced to merge.

A particular source of competitive concern for MFIs is the entry of commercial banks into the sector. There is a perception among the non-bank MFIs that the commercial banks are engaging in predatory practices in order to corner the market. They believe that banks such as Bando de Credito are willing to make large initial investments in their portfolio that even the largest MFIs cannot match in order to lend to an entire neighborhood. Some MFIs believe that the commercial banks are willing to take a loss of up to a quarter on their initial portfolio in order to identify who the good clients are and to sacrifice profits initially by undercutting MFIs in order to drive them out of business.

### ***Saturation and Unhealthy Competition***

Another ramification of increasing competition is the overindebtedness of MFI clients, which was consistently identified as one of the major risk factors facing the MF sector in

Peru. Industry players were in agreement that overindebtedness is largely supply-side driven. As one respondent put it, a microfinance loan is different from other products. If three people offer to sell you a book you will choose to buy a one of the books. If three people offer to give you money you'll take all three offers. In a competitive environment it is much less costly to identify promising clients by checking whether they are on time with their current loan with another MFI rather than visiting the client and developing an analysis of their microenterprise. The problem is that while these clients may be able to put one loan to productive use it is not clear that they have the absorptive capacity to do so with multiple simultaneous loans. There is some evidence that this problem is beginning to have an affect as a slight uptick in delinquency rates was seen in 2003. There was a concern stated by some interview respondents that the problem of overindebtedness has the potential for stimulating the types of social disturbances that were seen in the Bolivian microfinance crisis.

This first line of defense for managing this risk is for MFIs to work with the SBS Risk Center, InfoCorp and other credit bureau agencies to screen their clients. InfoCorp supplements the personal credit history that the SBS maintains based on formal MFIs' client information with credit information from a number of non-regulated MFIs and Peru's utility companies. While the credit bureau mechanism does mitigate the overindebtedness risk it does not fully eliminate it as InfoCorp's information is not real time (there is a six week lag from when the MFIs close their monthly books to when InfoCorp get access to the information). To fully manage this risk MFIs should consider greater cooperation on information sharing and increasing their efforts at client education.

### ***Institutional Risk***

MicroFinance is a new world for the traditional risk raters and they tend to punish MFIs because they are not familiar with them. Many of the best MFIs have a B rating even though they are not risky and should be rated as an A. Over time this situation is improving. For example, CMAC Arequipa started with a C rating from Fitch and is now a B+.

The market's perceived riskiness of the microfinance sector can also be seen in the spreads between MF rates and commercial lending rates. Currently, MFI microenterprise local currency loans are in the range of 50-60% as compared to a commercial bank lending rate of 14.2%, while MFI deposit rates are 11% as compared to commercial bank deposit rates of 3.8%<sup>16</sup>. Microfinance lending rates are also considerably higher than those of low risk government bonds. As of mid 2003, 180-day Peruvian sovereign bonds had a yield of 2.5%, one-year sovereign bonds had a yield of 2.9%, and five-year bonds had a yield of 6.6% (BCRP, 2003).

The relatively unique structure of different MFI types in Peru creates the potential for risk deriving from organizational structure. While the CMACs are the most attractive investments from a commercial standpoint their affiliation with their home municipalities is a source of some concern for investors. The municipality's oversight functions include

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<sup>16</sup> - Commercial bank rates from The MIX, MFI Rates from the SBS.

appointing three of the CMAC's seven directors and approving annual and financial reports. The CMACs must also return 50% of their profits to the municipality. There is some concern, which is denied by the CMACs, that there may be pressure put on these institutions to increase lending during election campaigns. It is also unclear what affect the fact that the composition of the board of the CMACs changes every three years following local elections has on long term strategic planning by the CMACs.

### ***Fraud***

The financial sector as a whole in Peru is tightly regulated and MFIs are required to make monthly reports to the SBS, undertake annual audits, and adhere to strict loan loss provisioning standards. These practices help to reduce the financial risks and the risk of fraud faced by formal MFIs. The risk of fraud occurring in the informal unregulated NGOs, which tend to have less sophisticated management information systems, is higher and does occur (as was seen most recently with PRISMA). It is acknowledged that while the self-regulatory body of COPEME is better than no regulation at all for the informal MFIs its voluntary regulation is less effective than that of the SBS. Donor oversight requirements are also seen as being less stringent than those of the SBS.

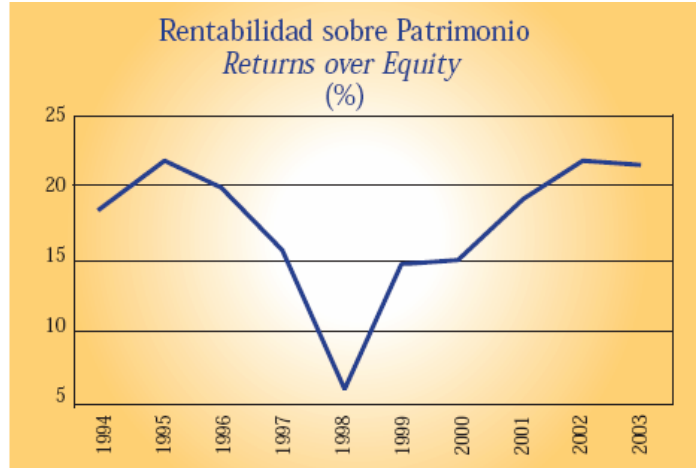
### ***Volatility***

Since the microfinance sector in Peru is relatively young (the CMACs and CRACs were not created until the early 1990s) it has not yet had to weather many political or economic crises.

There is a belief among interview respondents that the portfolio structure of MFIs allows them to be more flexible in responding to crises. In particular the short cycle of microfinance loans means that MFIs can more quickly restructure their portfolios and interest rates in the wake of a currency devaluation or inflation shock. The MF model of making a large number of small loans means that problems with any particular borrower are unlikely to threaten the viability of the MFI (as compared to a commercial bank where a bad loan to a large client could potentially threaten the institution itself).

There is some evidence to support the contention that MFIs are more able to withstand financial shocks than are formal financial institutions. For example during the financial crisis of 2001 when three major commercial banks collapsed, the MFIs were largely unaffected. In addition to the factors mentioned above, the clients of MFIs may be less affected by financial crises, thus further insulating MFIs. However, crisis stimulated by natural disasters, such as the El Niño-related weather changes in 1997, did affect the profitability and the portfolio quality of MFIs.

## MFI Sector Profitability



Source: SBS (2004) Las Nuevas Fortalezas de Peru.

This was especially true for those MFIs that work in the rural sector, such as PRISMA, which saw heavy losses in their agricultural portfolios. The MFIs did however weather this crisis better than the formal financial sector which went from 26 banks in 1997 to 14 by 2000. Despite the hit to their profitability and a deterioration in their portfolio quality during this period, MFIs were able to continue their decade long trend of increasing lending uninterrupted during this crisis.

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## **VIII. Profile of Agencies Participating in Interviews**

Asociacion de EDPYMEs – ASEP is the association of EDYPMEs. ASEP facilitates the channeling of resources from the financial and capital markets to EDYPMEs. It also provides management training and lobbying services to EDYPMEs.

FEPMAC provides the Cajas with training, auditing, representation before international bodies, supervision, recruitment of personnel, evaluation of projects, and lobbying services

Caja Municipal de Arequipa - CMAC Arequipa's mission is to offer financial services to segments of the population that have difficult access to the traditional financial system, in a self-sustainable and profitable way. CMAC-Arequipa offers credit to small and micro businesses as well as individual loans, agricultural loans and collateral loans.

Catholic Relief Services (CRS) – The mission of CRS is to assist the poor and disadvantaged, leveraging Catholic teachings to alleviate human suffering, promote development of all people and to foster charity and justice throughout the world. In Peru, CRS partners with Caritas which is in the process of converting from a semi-formal MFI to an EDPYME.

Consortio de Organizaciones Privadas de Promocion al Desarrollo de la Pequena y Micro empresa (COPEME) – COPEME is a civic asociation created in 1990 to promote and execute programs and activities that facilitate the development of micro and small enterprises at the local, regional, and national level.

Corporacion Financiera de Desarrollo S.A. (COFIDE) – COFIDE is second-floor development bank created in 1992. It complements the private financial sector by financing the medium and the long term, the exporting sector, and micro and small enterprises.

Cyrano Management - Cyrano is a corporation specialized in financial institutions and investment funds that service small businesses. Cyrano provides fund management, investor representation, risk assessment, consulting and training services, and market research to its clients.

Federación de Cajas Municipales (FEPMAC) – FEPMAC is the association of Cajas Municipales. FEPMAC provides the Cajas with training, auditing, representation before international bodies, supervision, recruitment of personnel, evaluation of projects, and lobbying services

Felipe Portocarrero- Portocarrerro is an expert in microfinance for USAID.

FINCA Peru - FINCA Peru works to ensure that low-income microentrepreneurs have the working capital they need to progress. It has operations in the regions of Lima,

Ayacucho, and Huancavelica and approximately 6,200 clients through 270 Village Banking groups.

**EDYFICAR** - EDYFICAR's mission is to facilitate the sustainable development of financial services to microentrepreneurs in order to increase the income of families in extreme poverty. EDYFICAR provides individual and group loans to microenterpreneurs. EDYFICAR was originally Care Peru, which decided to transform into an EDPYME in 1997.

**InfoCorp** – Infocorp is the principle credit bureau that collects and supplies information on the Peruvian commercial financial sector. It started collecting information on the microfinance sector three years ago in response to government initiatives to encourage greater availability of information about this sector.

**Mi Banco** – MiBanco is a private bank committed to the development of small and micro-businesses. Mibanco was created in 1998 by taking over the financial operations of the NGO "Acción Comunitaria del Perú" (APC) which had been working for the Peruvian micro-entrepreneurs since over 33 years. Mibanco strategy is to target markets where demand for micro-credit is highest and supply weakest.

**Pacific Credit Rating** – PCR is the only company in Peru dedicated to the evaluating of counter party risk that has international presence. PCR analyzes the financial strengths of MFIs to determine the future credit risk of individual institutions. It also conducts country risk analyses.

**PRISMA** – PRISMA is a Peruvian NGO that seeks to strengthen the capabilities of poor and vulnerable people so they are able to develop economically and socially by themselves in a sustainable way.

**Superintendencia de Banca y Seguros (SBS)** – The SBS is responsible for the regulation of Peru's financial system. Regulated microfinance institutions must report operational and financial results to the SBS on a monthly basis.

**OIKOCREDITO** - Oikocredit, as a worldwide cooperative society, promotes global justice by challenging people, churches and others to share their resources through socially responsible investments and by empowering disadvantaged people with credit.

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