The secret has gotten out that microfinance institutions can be profitable. As the news spreads, investors are positioning themselves to get a piece of the action. A variety of recently created funds provide resources to microlenders and help link them to capital markets in win-win deals that increase microlenders’ loan capital, bring a profit to investors, and channel money to microentrepreneurs with no other access to credit.

Conventional investors’ participation in microfinance is testimony to the successful track record of microfinance institutions during the last two decades and the growing trend of microlenders to convert to regulated institutions whose risks are supervised by national banking authorities.

The market for microfinance is enormous; existing institutions serve only a fraction of the estimated 500 million people worldwide who need financial services. In dollar terms, the amount of lending capital needed is also vast; in three Andean countries alone—Bolivia, Colombia and Peru—it could reach as high as US$300 million. Since neither international donors nor the microfinance institutions can provide enough resources to reach the waiting market, they must go where the money is: to financial markets around the world.
L-R: Fernando Lucano, CEO of LA-CIF; Alex Silva, CEO of ProFund; and Francisco (Pancho) Otero, founder of Banco Sol, Bolivia.
Sophisticated new funds—such as ProFund Internacional (Costa Rica), the Latin American Challenge Investment Fund (Peru) and Triodos Bank (Holland)—that can boost the lending capital of microlenders reflect the trend toward creating “second tier” institutions which lend to microcredit portfolios.

**ProFund: Public–Private Partnership for Profit**

“We seek to have a demonstration effect, to show that microfinance and microcredit can and must be a function of traditional banking,” says Alex Silva, CEO of ProFund. The fund is dedicated to achieving “superior financial returns for its investors by supporting regulated, efficient financial intermediaries serving primarily small and microenterprises in Latin America and the Caribbean.” ProFund operates on the theory that if its investments in microfinance institutions turn a profit in 10 years, the fund will have proved that microcredit is viable for commercial banking, Silva says.

Created in 1995 with $22 million, ProFund sees itself as a public sector partnership for profit. A 10-year closed-end fund, it was established with capital put up by four multilateral and bilateral donors, three non-governmental organizations and two private investment funds dedicated to ethical investing. The donor agencies hold 76 percent of the shares; NGOs, 16 percent; and private investors, 8 percent. So far, ProFund has earned a higher than expected return and met its commitment to hold annual operating expenses to less than 3 percent of total capitalization; because the portfolio is concentrated in investments that have not matured, however, it cannot yet predict the return on investment, Silva reports.

The fund invests in three types of microfinance institutions: non-governmental microlenders that are converting to regulated institutions; traditional financial intermediaries with subsidiaries dedicated to microfinance; and non-bank intermediaries, such as leasing and factoring companies, that serve micro and small enterprises.

ProFund has invested $16.2 million in 10 microfinance institutions in the Andes and Central America, the Latin American regions where the microfinance sector is most highly developed, says Silva. The fund is seeking new investments in Guatemala and Haiti.

**LA-CIF: Linking Microfinance and Capital Markets**

The Latin American Challenge Investment Fund is designed to introduce investors to the risks—and profit opportunities—of short-term investments in microfinance and small-business banking institutions, says Fernando Lucano, CEO of LA-CIF. The tool used to persuade conventional investors to take a stake in small-scale banking is risk analysis for investments that include loans, bonds and guarantees.

LA-CIF projects that it will offer an average 11 percent return on investments over the three-year period that ends in 2002. Although this is based on the expected performance of sound microfinance institutions, it is backed up with compelling evidence; the LA-CIF analysis of the best five microlenders in Bolivia and Peru—where microcredit is highly developed—show average returns on equity ratios of 10 percent in Bolivia and 30 percent in Peru, even while both countries were suffering marked economic slowdowns.

The fund attracts financing to microlenders by structuring transactions for local institutional investors. It puts together deals that include simple guarantees to back a local bank which lends to a microfinance institution; syndicated loans and bonds; or paper issued on local markets by microlenders, says Lucano.
To give investors adequate market information, LA-CIF prepares macroeconomic risk analyses that examine country risk, policies on interest rates and foreign investment, and regulatory standards, says Lucano. In addition, the fund prepares risk analyses of the microfinance institutions that cover their liquidity; quality of their loan portfolios; adequacy of their capital reserves and loan loss reserves; profitability; and the match of currencies and loan repayment periods.

Created in 1999 with commitments of US$5 million, LA-CIF aims to use these funds to generate US$35 million by 2003. The shareholders include nine multilateral and bilateral aid agencies and one NGO.

LA-CIF finances only regulated institutions, such as banks, finance institutions and cooperatives. The investments are made at market interest rates for 180 days—which can be extended to three years—for a maximum of US$750,000 or 20 percent of the assets of the client. If the client defaults, the repayment schedule is accelerated and other protections are applied, says Lucano.

The fund invests in four types of capital market instruments: direct loans denominated in U.S. dollars for micro-lenders in highly dollarized economies; syndicated loans, to reduce the borrowing costs of microfinance institutions and small-business banks; bonds and certificates of deposit issued by microfinance institutions; and direct guarantees, provided by a letter of credit from a local bank and additionally backed by the U.S. Agency for International Development.

Triodos Bank: Ethical Savers and Profit-Making

The Triodos Bank, a commercial lender with a social purpose, began lending to microfinance institutions in the 1990s, when its savers demanded that bank resources be directed toward developing countries in the Southern Hemisphere, says Eric Guerts, senior investment officer of Triodos Bank. As part of this mandate, since 1993, lending to microfinance institutions has become one of the main lines of action of the bank.

Triodos Bank attracts funds from ethical savers and invests in companies that benefit society either by protecting the environment through organic agriculture or by using renewable energy sources.

The bank offers several types of products to microfinance institutions, including long-term loans, convertibles, and subordinated debt; and purchase of shares, says Guerts. Through the North-South account, which is funded by 800 private investors, Triodos offers loan guarantees. In seven years of financing microfinance institutions, the bank has made loans to financial institutions in Bolivia, Ecuador, Guatemala, Peru and El Salvador. In Africa, Triodos more commonly takes equity participations in microfinance institutions.

Since 1994, the bank has intensified its emphasis on fee products that include insurance, fund management and research for ethical investments.

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**LA-CIF SHAREHOLDER PARTICIPATION**

<table>
<thead>
<tr>
<th>Organization</th>
<th>Share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>MIF (Multilateral Investment Fund)</td>
<td>31.4</td>
</tr>
<tr>
<td>Norfund – Norway</td>
<td>26.2</td>
</tr>
<tr>
<td>Desjardins – Canada</td>
<td>13.1</td>
</tr>
<tr>
<td>CARE – Ecuador</td>
<td>6.5</td>
</tr>
<tr>
<td>Argidius Foundation – Switzerland</td>
<td>5.2</td>
</tr>
<tr>
<td>Swefund – Sweden</td>
<td>5.2</td>
</tr>
<tr>
<td>Swedish Central Cooperatives</td>
<td>5.2</td>
</tr>
<tr>
<td>Scdf – USA</td>
<td>2.4</td>
</tr>
<tr>
<td>SIDI – France</td>
<td>2.2</td>
</tr>
<tr>
<td>MEDA – Canada</td>
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</tr>
<tr>
<td>FUNDA-PRO – Bolivia</td>
<td>0.6</td>
</tr>
<tr>
<td>Etimos Italia</td>
<td>0.4</td>
</tr>
<tr>
<td>Enlace Ecuador</td>
<td>0.4</td>
</tr>
<tr>
<td>Fundes Switzerland</td>
<td>0.4</td>
</tr>
</tbody>
</table>

**LA-CIF 2000–2001 PORTFOLIO**

<table>
<thead>
<tr>
<th>Organization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bolivia: Caja Los Andes, FFP</td>
</tr>
<tr>
<td>FIE, Prodem</td>
</tr>
<tr>
<td>Peru: Cajas de Arequipa y Tacna / Mibanco / EDPYMES: Crear-Tacna, Proempresa, Confianza</td>
</tr>
<tr>
<td>Dominican Republic: Adopem</td>
</tr>
<tr>
<td>Nicaragua: Finde</td>
</tr>
<tr>
<td>Ecuador: Banco Solidario</td>
</tr>
<tr>
<td>Paraguay: Visión de Finanzas</td>
</tr>
</tbody>
</table>


—BY LUCY CONGER
Bankers are seeking out microbusinesses and self-employed entrepreneurs these days for a simple reason: in developing countries, they represent an enormous market crying out for financing, and these businessmen and women have proved to be solid credit risks. “When we looked around, we became aware that microenterprises were the majority segment,” making up over 70 percent of the work force, says Danilo Chavez, operations and finance manager for Solución, the arm of Banco de Crédito del Perú that serves nonconventional banking customers.

Lending to self-employed businesspeople, whose earnings are often unpredictable, presents a host of challenges for banks such as Solución, which grants loans averaging a modest US$1,300, and Banco del Trabajo del Perú, with 100,000 microentrepreneurs among its client base. Peru had no credit bureau that Solución or Banco del Trabajo could turn to when they began their microfinance operations.

Both banks have focused on developing loan evaluation methods to reduce their risk and shorten the time-consuming credit assessment process of clients with no formal jobs and irregular income who are hard-pressed to offer conventional guarantees. Each of the banks has adapted some of the techniques of credit scoring, a method that reduces administrative costs and has been used in wealthy countries to predict risk based on clients’ performance on past loans.
Solución has adopted a number of tactics to address the difficulties of managing loans made from 27 offices in Lima and scattered across 20 of Perú’s provinces. “We hired as quickly as possible staff from the cajas municipales (municipal savings and loan associations), and we bought their know-how,” says Chavez. That move gave Solución a force of loan officers experienced in microlending.

Several formulas are used to prevent over-indebtedness by borrowers. Solución loans up to the value of one month of sales and controls the repayment schedule so that monthly payments are no more than 30 percent of monthly profits.

The Solución adaptation of credit scoring centers on its database, which contains the track records of good clients during the previous three years. Using these records of loan repayments and arrears, Chavez says, the bank is generating a profile of a good client who repays reliably and a bad client who is a credit risk. The point system also distinguishes self-employed entrepreneurs from workers holding steady jobs.

Solución’s policy is to grant smaller loans without a full credit analysis, deploying loan officers only to verify the existence of the business. For larger loans, the officers inspect the business to make sure cash flow is sufficient to meet the repayment schedule and cover other costs. The credit scoring will reduce the bank’s operating costs by eliminating the need for many of the on-site visits.

Banco del Trabajo del Perú opened its doors in 1994 with the objective of serving people in the lower income brackets. “With an income of US$100, you’re a client,” says Carlos Fernández, former central sales manager from Banco del Trabajo.

The bank adopted a cautious approach. It initially lend only to workers with steady jobs and made starting clients with small loans that were subsequently raised to higher amounts after timely repayment. Rather than give loans, Banco del Trabajo offers a line of credit so that when the client repays, another “loan” is granted for the same amount, Fernandez says.

The bank adopted a new way of evaluating loans based on the “total separation” of the sales force from the loan officers, says Fernandez. The officers have learned how to evaluate the microenterprises, even though the loan applicants typically keep no records and rarely declare their real income. “We are seeing only a piece of the business,” he says. With training, loan officers have learned how to assess the none

Microfinance scoring models could predict the risk—and the length—of default; the probability that good clients would not seek more loans; and even the potential profitability of a client to the lender.
microentrepreneurs’ real income, cash flow and payment capacity.

With experience, Banco del Trabajo has created its own credit-scoring system, which rates variables such as age, sex, marital status, number of children, occupation and whether the client owns property and a telephone. Scoring has shown that the best credit risks are clients who have been in the same line of work for more than five years and who own property. Women are better payers than men, especially women over 40. And microentrepreneurs who produce or trade basic necessities have better repayment records than those who work with seasonal products. Scoring favors microentrepreneurs who are producers and disfavors vendors and merchants, reducing their eligibility for loans.

These experiences in Peru reflect a trend toward adopting credit scoring, which is expected to be the next important technological innovation in microfinance, says Mark Schreiner, a professor of social work at Washington University in St. Louis, Missouri. However, microfinance institutions must beef up their technical capacity if scoring is to succeed.

Credit scoring requires a computerized database on the characteristics of clients; their loans; and the length and amount of each default, says Schreiner. Microfinance scoring models could predict the risk—and the length—of default; the probability that good clients would not seek more loans; and even the potential profitability of a client to the lender. These models would help the microfinance institution set special interest rates for riskier loans, determine when to visit risky borrowers and create incentives for good clients to borrow again, he says.

The use of scoring has led to some interesting findings. In Bolivia, a borrower with a past record of 15-day arrears is likely to repeat the pattern, and a first-time borrower is a slightly higher risk than a second-time borrower. In Colombia, a loan with a greater number of installments is more likely to fall into default, according to Schreiner’s research. Information such as this can reduce risk and show the lender how to structure loans for the best results.

While the banks have been working to lower their credit risk, lending to microentrepreneurs does just that. “This segment in times of recession performs better than medium and large businesses,” says Chavez. This is because larger companies are saddled with fixed costs which compel them to take on debt that becomes burdensome during downturns.

Microenterprises have no fixed costs; they have the flexibility to reduce costs and can adjust their work force by enlisting family members in times of need; and they can benefit during economic downturns as consumers demand the less expensive products made in rustic workshops. However, the microenterprise sector is vulnerable to inflation and the “monetary illusion” it brings, cautions Chavez. Micro and small businesses sell at one price but tend to forget that they will have to replace their inventory with goods they buy at a higher price.

Beyond the economic reasons that explain why microentrepreneurs make good borrowers, there is a psychological motive that reduces risk to banks. “They show a very good credit performance; they are people who value greatly their credit rating,” says Guillermo Zarak, general manager of Solución.

—BY LUCY CONGER
As microfinance institutions in Latin American and other regions of the world continue to grow and diversify their services, investors and analysts are putting microbanks under their steely-eyed gaze.

MicroRate, a pioneering organization in the field of independent analysis of microlenders, specializes in preparing detailed examinations of microfinance institutions. “We provide information for sophisticated investors who are interested in knowing where the microfinance funding goes,” says Damian von Stauffenberg, director and founder of MicroRate. The information allows investors, creditors and donors to track the performance of the institutions they fund.

Capital markets are signaling a growing willingness to invest in microbanks. The pioneers in this venture include ProFund and the Latin American Challenge Investment Fund, backed by private investors as well as development banks, which buy shares or take stakes in microfinance institutions. For these and other private commercial investors, the conventional credit ratings prepared by the international rating agencies, such as Standard & Poor’s, Fitch-ICBA and Moody’s, are invaluable tools for investors.
assessing the risk of an investment object. Ratings hold out many promises for microfinance institutions. “Rating is a great instrument to be able to raise funds on better terms and leverage my portfolio better,” says Eduardo Bazoberry, president of FFP Prodem, a specialized Bolivian financial institution with about $25 million in loans to microentrepreneurs. A good credit rating will open up new alternatives for microfinance institutions seeking to get investors to expand their loan capital.

By applying ratings to microbanks, Peru leads Latin America in putting microfinance under the microscope of conventional financial analysis. In the last three years, Peru’s cajas municipales, city-sponsored savings and loan associations, began requesting ratings. “It implied opening our minds because it was another experience,” says Elke Braun, financial analyst for Apoyo y Asociados Internacional, a Lima rating agency that is a partner of the international firm Fitch-IBCA. Previously, Apoyo had rated only commercial banks.

Braun has had some pleasant surprises in her examination of microlenders. In the loan portfolios of the stronger cajas, Braun saw the ability of microlenders to continue making loans successfully even while riding out an economic crisis. This tricky balancing act is made possible by the resilience of the microentrepreneurs who take out the loans. “Microentrepreneurs are very flexible, so if their business goes broke they are already thinking up another one,” she says. Risk tends to be well spread over the cajas’ portfolios—they can typically boast of a diversified group of savers, numerous loans, low default rates and coverage with high loan loss provisions. Compared with commercial banks, “the cajas seem to hold quite well in terms of loan arrears,” she continues (see graph).

Compared with banks, the cajas and other microlenders typically have a more intimate and detailed knowledge of their borrowers. “With cajas, the relationship is broader—they analyze the balances [of the microentrepreneur loan applicant], visit the business and the family, see the family’s income and expenses and their state of health,” Braun says. In short, the caja loan officers verify the holdings of their clients through on-site inspections, which offer a good idea of their ability to borrow.

Still, weaknesses are inherent in serving a clientele of often vulnerable micro and small businesses. The activ-
ity of the cajas municipales is highly cyclical, reflecting the rhythms of the microbusinesses they finance. In Cuzco, lending is driven by tourism; in the northern coastal state of Piura, credits rotate with the agricultural seasons; and everywhere, the Christmas holiday and local patron saints’ festivals cause a spike in defaults. Loan guarantees are inadequate because the collateral offered is often used electrical appliances worth nothing in the market. Even so, default rates remain very low in the microfinance industry compared with the nonperforming loans in commercial banks.

Another point of vulnerability for microfinance institutions lies in the instability of savings among microenterprise clients. Cajas accept savings deposits, and about 70 percent of short-term deposits are held in U.S. dollars. Fewer than half of the loans are made in hard currency. The potential currency risk in this mismatch is minimized because most deposits are held for less than 30 days, while loan repayment periods average between 12 and 18 months, Braun says.

Cajas also compete with other handicaps. The cajas do not have an extensive network of branch offices, so they are unable to achieve economies of scale, and their operating costs are higher than those of commercial banks. Also, the cajas spend too much to get lending capital, paying high interest rates to development institutions.

Beating down borrowing costs and becoming eligible to receive deposits are the leading incentives for seeking a rating. The ultimate goal for microfinance institutions—being able to tap the capital reserves of Peru’s pension funds, a huge potential source of investment—would require achieving the high rating of A. Still, securing a B rating (B+, B or B-) for two consecutive years entitles microfinance institutions to be qualified by the Superintendency of Banks to expand their range of products and compete on a more equal footing with commercial banks in lending and in receiving deposits.

So far, only five of the 35 formal microfinance institutions in Peru hold ratings. These include three cajas municipales and two commercial banks. However, seeking ratings is expected to become a growing trend that will eventually reach many of the cajas and the non-governmental credit organizations that have recently converted to regulated institutions.

While ratings hold much promise for microfinance, the process of rating an institution is not an exact science. For example, when Mibanco, a commercial bank specializing in microfinance, was first rated, Apoyo gave it a C+, a classification that implies that more loan loss provisions are needed. So Mibanco Director and General Manager Manuel Montoya, following a practice common among sovereign debtors, sought a rating from a competing agency, Equilibrium, which awarded it a B. “I’m trying to see that the rating nomenclature for microfinance be different,” he says.

As microfinance evolves, rating will act as a check on excess risks in the loan portfolios of microbanks. For example, if the cajas of the provincial capitals of Arequipa and Piura realize their plans to launch lending in Lima, their staff will need additional training and procedures and their ratings—which are reviewed every six months—could suffer, Braun cautions.

Microfinance institutions will become a growing source of business for the rating agencies. “This is our future,” says Oscar Jasai, general manager of PCR, Pacific Credit Rating, Peru, the ratings operation that covers Peru, Bolivia and Ecuador. He sees the business expanding beyond rating microfinance institutions. At the Inter-American Development Bank’s sponsored microfinance forum in Barcelona, Jasai talked with representatives of other organizations to gather ideas for his new project to develop a methodology for rating micro-businesses. That would refine even further the knowledge of risk in the portfolios of microfinance institutions.

—BY LUCY CONGER AND TOR JANSSON