

# en breve



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## From Financial Exclusion to Inclusion Increasing the Availability of Credit to the Urban Poor in Latin America

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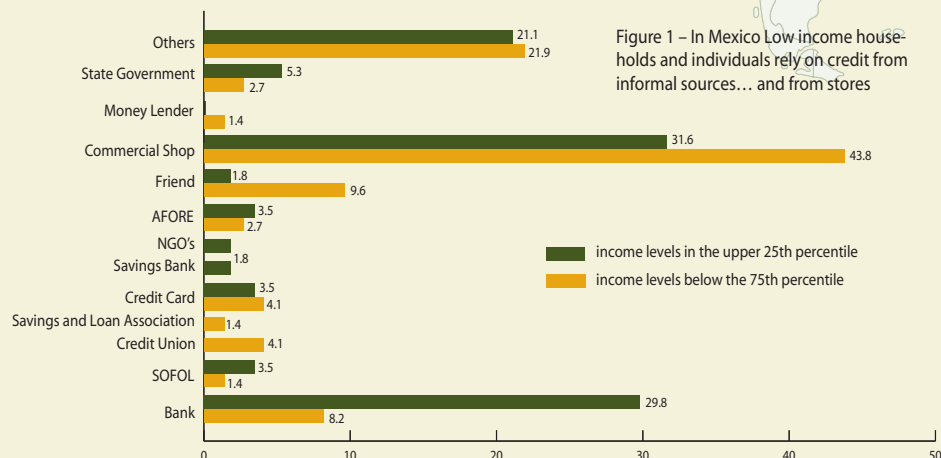
This is the second of two articles<sup>1</sup> that draw on the results of recent studies of the links between financial services and low income communities in Latin America. While the focus remains on the nature and inherent costs of “financial exclusion” for the “unbanked”, those without basic deposit and transaction accounts, this article focuses on access to credit and on some of the efforts that have been made to increase the availability of credit services to the urban poor. It closes by describing ways in which World Bank projects could support increased private sector lending for community development, including housing, home improvement, and basic physical and social infrastructure as well as micro and small business lending.

**The majority of the urban population in Latin America are unbanked and the majority of unbanked are hard core poor.**

As noted in the previous article, studies in Mexico,

Colombia and Brazil found the rate of ‘bancarizacion’ to run between 15 – 35%<sup>2</sup>, suggesting a dramatic difference between Latin America and OECD countries, where rates range from 91%-97%. The unbanked population is markedly poorer, less educated, and dependent on the informal economy, as compared with the banked population. The poor make up the majority of the unbanked. Although in all three countries the unbanked expressed strong interest in obtaining financial services, they consistently identified access to deposits, savings and payment services as priority and cast the need for credit in a second plane. At the same time, the studies showed that those unbanked who do borrow from non-banking institutions pay high costs that can represent a serious portion of their incomes.

Figure 1<sup>3</sup> shows, that where people borrow differs according to income level although factors of education and informality associated with being unbanked obviously come into play.



*“Los Aboneros” offer credit door-to-door in Mexico’s low-income neighborhoods.*

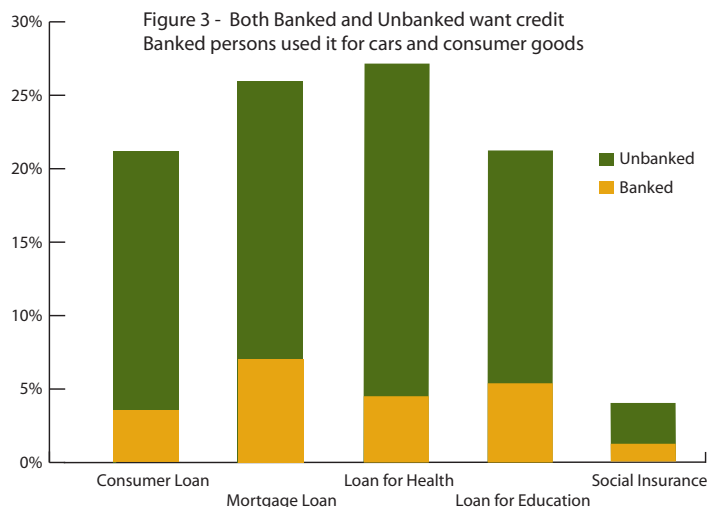
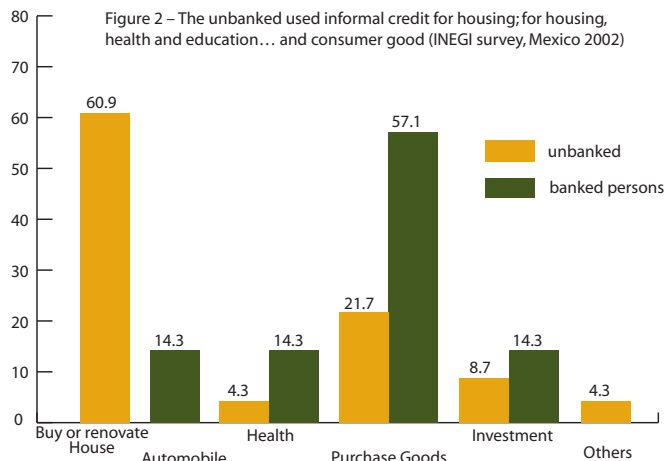
In Mexico City’s informal settlements residents report that they buy household goods such as sheets, towels, pillows, mattresses, dishware and cutlery from door-to-door sales people who offer payment terms over time. While residents could not report the interest rates they pay on these purchases, they recognize that the sales prices are marked up some 30- 50% over the “cash discount price” and must be paid off in three months. “It’s how I buy things,” says Sra Fabiola Morales of Tlalpan, “they bring what I need to my house and charge me what I can afford. Yes, it’s more expensive but with all I have to spend to keep my house going I could never save up the money to buy for cash.” Source: Marta Ferrer, 2002

In surveys the unbanked and low income population groups consistently report a lower propensity to request loans than high income groups. In Mexico less than 9% of unbanked persons reported they had requested a loan in the past three years compared with some 20% of banked persons. Nonetheless, some 43% of the unbanked group reports buying on credit from commercial stores. This data does not cover buying on credit from door-to-door salespersons who, our focus group members revealed, serve as a prime source of commercial lending. To many interviewees, buying on credit does not seem to be in the same category as borrowing money. None could report the interest rates they were paying or even the full price of the good. They referred to the cost of the weekly payment instead. All told, the costs associated with commercial credit are high even compared with informal lenders. At the time of the survey nominal annual bank rates in pesos ran between 18.6 % in 2001 and 24.2% in 2002 in Mexico<sup>4</sup>. In Colombia, credit card charges can reach 36% and 40% per year. On the other hand, loans from commercial stores, money lenders and pawn shops start at 10%/month and are reported up to 35% per month (150% to over 400% per year)<sup>5</sup>. It should not be surprising that respondents reported the preferred source of loans to be friends and relatives, the source in about a third of cases.

Do the unbanked want credit ? At these prices, one may ask, why do a total of 13.5% of the total population (20% of the banked population and 10% of the unbanked) seek loans from informal money lenders each year? The answer involves the loan purpose. Figure 2<sup>6</sup> shows what persons borrowed for, and shows how the answer varies for banked and unbanked persons. The unbanked borrowed primarily to invest in housing or home improvements – something not available via commercial credit<sup>7</sup>. Figure 3<sup>8</sup>, which shows the kind of credit service people most want, reinforces the notion that families borrow for what they can, not necessarily for what they would like. Although a bit over 20% are interested in credit for commercial purchases, over seventy five percent list their first choices for credit as health, housing and (in third place) education.

**Can commercial banks offer credit for housing to the informal sector ?**

A few commercial banks in Latin America have begun to test the waters, reaching down scale. At the same time, non-bank financial institutions (NBFIs) including non-governmental organizations (NGOs) and microfinance



institutions (MFIs) that traditionally focus on low income groups with credit products are looking into broad based banking to increase funding sources. The Sustainable Development Network in the Latin America and Caribbean Region of the World Bank has begun to explore innovative programs to encourage private banks to offer credit to groups which are traditionally “unbanked” for housing and community services. Behind these efforts is evidence that banks focus on the upper-most income segments because of the cost of small transactions, imperfect risk pricing, and asymmetric information. The World Bank can help to bridge the gap between traditional institutions and low-income populations by encouraging the use of new technology and business models that permit banks to profitably reach lower-income populations. Key to such efforts is to avoid subsidizing credits, but rather to reduce the uncertainties and costs of doing business<sup>9</sup>.

**Quality certification plays a crucial role in ensuring the sustained engagement of financial institutions in channeling microloans for infrastructure.**

Enhancing access to credit represents only a partial response to the overall problem of improving private sector lending for community development. The recent success of the solar program within the Off-Grid Rural Electrification Project (Perza) in Nicaragua demonstrates that the World Bank can play a key role in setting up standardized certification procedures guaranteeing the reliability of private sector participants in infrastructure projects and the quality of the products used (i.e. solar panels in the case of Perza). Started in mid 2005, the solar program of Perza has already delivered 1,500 solar home systems to un-electrified families, totalling some 7,500 people. Given the quality of the systems installed and the reliability of the small companies involved in the provision of the panels, local microfinance intermediaries were able to finance up to 25 percent of those systems. This financing mechanism was essential for poor households who could not afford to buy the systems on cash but had to rely on (up to two years) micro-loans adjusted to their repayment capacities. Initiatives such as Perza show that an enabling environment is a necessary condition to expand financial services for poor people deprived of basic infrastructure services as it substantially dampens the financial risks of non-payments due to poor material quality or customer service.

Some large lenders are considering how to better serve low income households. Peru's Banco de Credito has experimented with branches and automatic teller machines in low-income neighborhoods of Lima. Guatemala's Bancafe has lent to community development organizations that in turn provide micro credits to low-income individuals, and Banrural is experimenting with touch-screen automatic teller machines that offer menus in indigenous languages (see Box 1). India's ICICI makes micro loans both to MFIs and directly to low-income borrowers.

**Guatemala Community Infrastructure Project proposes a credit guarantee incentive to finance home improvements and basic infrastructure.**

The Bank is currently discussing an operation with the Guatemalan government which would create a facility that would provide partial credit guarantees for commercial bank lines of credit to MFIs. In turn, MFIs would on-lend to low-income households for a broad range of housing and community services. The idea is to make use of the commercial bank business model, which maximizes the size of a transaction, with that of the MFIs, which involves extensive personal contacts with clients and a greater knowledge of low-income neighborhoods.

In recent years, a number of microfinance institutions that started out with loans for micro enterprises have

*Box 1 - Guatemala's commercial banks move into microfinance*

Two of Guatemala's leading commercial banks have made bold moves in the past year to develop new business lines which emphasize microfinance lending, including credit for informal housing and are aimed at a new customer base. El Banco G&T Continental, and BANRURAL have announced plans to open new branches in rural municipalities and peri-urban neighborhoods to seek out clients among the "unbanked". The new offices emulate the "corner store" in looks, built and are decorated in consciously simpler in styles than the traditional stately banks in Guatemala City. Bank officers attend clients in indigenous languages, and the ATM machines offer a choice of languages, or "picture" options for those who don't read Spanish. The Banks have definitely been paying attention to the MicroFinance institutions. G&T Continental has recently hired the Director of Genesis Empresarial and its Credit Manager to head up their new MicroFinance Department.

moved into lending for a variety of purposes. Well-known examples include Bangladesh's Grameen Bank, Bolivia's BancoSol, and Mexico's Compartamos. Loans for housing renovations now make up 8 percent of loans at Guatemala's Genesis Empresarial, and 17 percent of loans at Peru's MiBanco. Microfinance loans for housing can speed up the self-construction process, improving client's standard of living by simply replacing substandard construction or by providing them with new rooms that they can rent for additional income.

MiBanco's housing microfinance product serves households earning less than the median wage for home improvement and expansion. Credits average US \$1,600 and are extended for up to 5 years at interest rates of 25 percent, somewhat below the market rate for enterprise microenterprise finance in Peru. Borrowers typically pay off ahead of loan maturity, and actual terms average 20 months. Loans are secured mainly by co-signers, personal collateral, and by temporarily taking custody of households' proofs of ownership until credits are paid off. As with microfinance in general, the main incentives for repayment are assiduous methods of loan collection and the promise of access to future credits.

MiBanco made over 180,000 MiCasa loans between December 2000 and May 2006. In total, the program has disbursed US \$90 million, an average of US \$2.5 million per month. Thirty day arrears rates at that time were 1.9 percent; return on equity was 7 to 9 percent per annum, both sustainable rates.

Both Genesis and MiBanco have found technical support for the construction process to be crucial to good outcomes, especially given the earthquake risks in each country. Self-built houses are often the first to fall in an earthquake. Loan officers inform households, extend credit, and collect payments. A technical expert provides a plan for each renovation project that ensures that it complies with building codes.

### **Innovative solutions for improving basic physical infrastructure of poor communities can also come in the form of supplier credit.**

Cemex, the multinational cement company based in Mexico, piloted an innovative credit scheme enabling very poor people to upgrade and build their homes. The pilot program, called Patrimonio Hoy, offers microcredit for purchasing of raw material in the form of solidarity group loans. To assess clients' repayment capacity, microcredits are initially matched by an equal proportion of people's savings. No credit history or collateral is required, but each of the members in the group should commit to pay 120 pesos weekly for at least 70 weeks. Material deliveries occur in various stages to assure members keep up with their weekly payments and stay committed to the program. In 70 weeks, the household will be able to build a 9m square house. The expansion of the program has been impressive: Patrimonio Hoy (PH) currently has a presence in 23 cities reaching more than 75,000 households who have built the equivalent of 33,000 additional 110 square feet rooms. In addition to the lack of expertise and planning in housing construction, PH team found that the lack of financing schemes tailored to people's repayment capacity was the biggest challenge for poor households willing to upgrade their homes.

The experience of Genesis, MiBanco, Patrimonio Hoy and other housing microfinance programs demonstrates that:

- (a) large-scale housing microfinance can be profitable;
- (b) partnerships between building materials suppliers and microfinance lenders are key to building loan volume as well as achieving good results with construction; and (c) the public sector can support housing microfinance by providing liquidity to the system, and must allow institutions to set loan

terms and operate their programs commercially. Although interest rates are likely to start out high, competition among lenders can drive them down.

Brazil's government has developed alternative service payment systems and regulations to encourage access to savings. Measures taken by government in 2004, at the time that the Bank's studies on Access to Finance in Brazil were being carried out, follow a U.S. "CRA" model in requiring Bank disclosure of location and income levels of clients. At the same time the government has introduced certain regulatory requirements to encourage offering of affordable savings accounts, to extend micro-credit, and initiated a housing subsidy credit-linked scheme to reduce the risk that banks perceive in working with the poor while working with the judicial to enforce legal dispositions to all income class of costumers<sup>10</sup>.

**Summing up** While still scattered and small-scale, there are examples of financially viable credit programs aimed toward low income families. Commercial banks may be moving toward the lower ends of the market, sometimes with encouragement from government programs. The Sustainable Development Network in Latin America and Caribbean Region of the World Bank is exploring ideas with governments and with banks to support programs which broaden access to credit to the unbanked populations.

### **Notes and References**

- 2 Measured as the percent of households with at least one person holding a deposit account in a regulated institution, as in commercial banks, "social interest" banks, cooperatives, credit unions, etc.
- 3 INEGI Survey, Mexico 2002
- 4 CONDUSEF web page
- 5 World Bank, 2006; Solo and Manroth, 2006
- 6 World Bank, 2006
- 7 The banked group, on the other hand, borrowed primarily to buy goods and services, suggesting that they were able to get loans from a "prestamista" at a better rate than the vendors'
- 8 Ibid.
- 9 See for example Stijn Claessens, "Access to Financial Services: A Review of the Issues and Public Policy Objectives," The World Bank Research Observer, Vol. 21, No. 2, Fall 2006
- 10 See Housing Programatic Loan (Report 31756-BR, May 11, 2005)

### **About the Authors**

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