

Microcredit in Latin America and the World: Are We Better Off?

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CARMEN WELCOMES US into the living room of a modest apartment in Santo Domingo, Dominican Republic, and kindly shares her business experiences. Two years ago she was looking for a job but did not find one. A friend suggested approaching a microcredit institution where she obtained a DR\$3,000 loan (approximately US\$80) that she used to buy and sell clothes. Nowadays she makes DR\$4,000 per month selling clothes and costume jewelry; if she had a higher income she would increase her food spending. She complains about bad luck in business, and she would get a job if she could.

Norma is attending a client in her *colmado* (small convenience store) while telling us about her life experience. She divorced five years ago and needed to find a source of income. Her illiteracy made it difficult to find a job; instead she started selling products among friends and neighbors using a DR\$3,000 loan from a local bank. Last month the bank extended a DR\$16,000 loan for her successful *colmado*. She estimates a monthly profit of DR\$20,000, but keeping the house and the business money together makes it difficult to come up with an accurate figure. Happy about her income, she has no intention of expanding the business or finding a job. Her *colmado* is attached to her house; thus, she can work and take care of her family.

Jorge meets us outside his warehouse where he is loading a *guagua* (Dominican expression for pickup, van, or bus). He used to work in a big retail chain, but started his own convenience store using a DR\$10,000 loan from a local bank. Currently, he owns a small food distribution company that employs two drivers and two salesmen. The business monthly sales are DR\$400,000 (approximately

US\$10,000); however, Jorge does not have an accounting system and does not know his margin of profit. Looking at his facilities, though, one sees what appears to be a promising, growing business.

These cases illustrate how diverse microfinance is: a source of prosperity for some, but a poor alternative to unemployment for others. They also illustrate how microlending is shaping the lives of millions of people around the globe. In Latin America and the Caribbean alone, there are more than 18 million microcredit borrowers, and the number is growing rapidly.

In this article, we explore the microcredit market in Latin America and how it compares to microcredit in other parts of the world. We also describe more general aspects of microfinance, such as its cost structure, the relevance of loan officers in the lending process, and the challenges to improve microfinance effectiveness.

Overview

After its initial emergence in South Asia, microfinance, and especially microcredit, has become available in many countries around the world. By 2011, 382 microfinance institutions (MFIs) operated in Latin America and the Caribbean (LATC) alone; this is 158 more MFIs compared to South Asia. The gross loan portfolio in LATC has grown steadily over the last decade, reaching US\$28 billion outstanding in 2011—making it the second largest region in the world in dollar terms right after East Asia and the Pacific, and well above South Asia.

Nonetheless, the number of microcredit borrowers is still three times higher in South Asia (18 million borrowers in LATC, 50 million in South Asia). This leads to substantially different average loan sizes across regions. In LATC, the average loan balance per

Figure 1. Total Portfolio in US\$ Billions

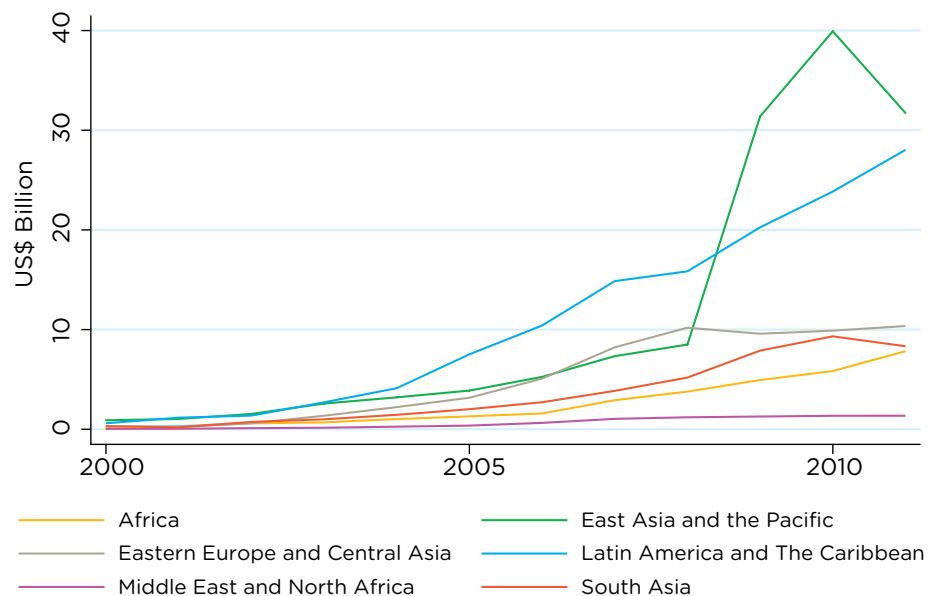
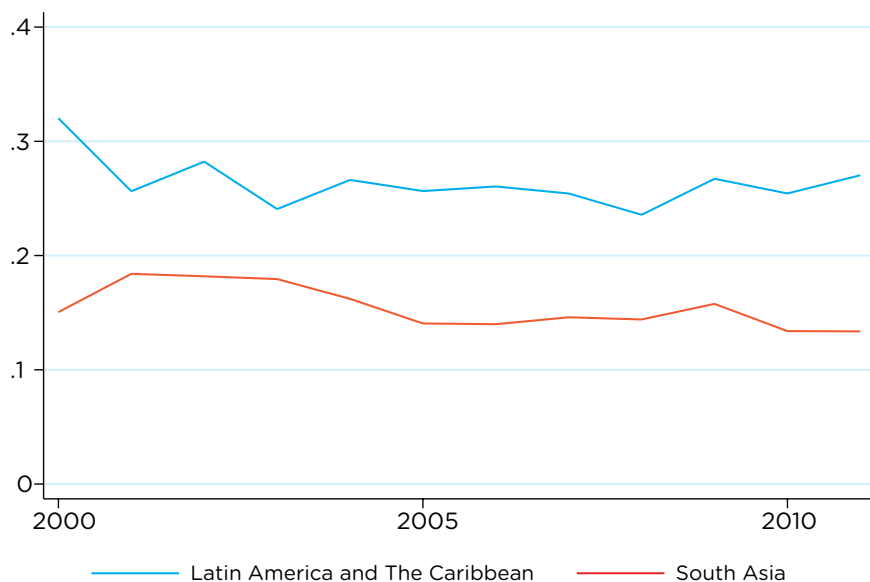


Figure 2. Loan Size / GNI per Capita



borrower is US\$1,527, while it is only US\$166 in South Asia. Relative to the gross national income (GNI) per capita, the average loan size has ranged between 24% and 32% in LATC and between 13% and 18% in South Asia. This type of comparison sets the loan size relative to the individual output and hence is a better indicator of leverage per borrower.

Intuitively, the phenomenon of a higher average loan size in LATC is easy to grasp; while US\$200 in South Asia may help in starting a microenterprise, it most certainly will not in the region of LATC where relative wages and other production inputs are much higher. However, the gap in average loan size reflects the differences in the type of borrowers targeted by microlending in

each region. While in South Asia many loans are allocated to entrepreneurs at subsistence level, in LATC entrepreneurs at subsistence level often do not have access to the credit market or do not want to participate in the formal financial system. Those who do not participate might find it easier or safer to look for a job rather than start a microbusiness; others might find strong support from the government. For example, in Chile, the average loan size is US\$6,217. The average loan size increases because the most vulnerable people find strong support from the government and thus prefer to avoid getting into debt. Indeed, the governmental agency FOSIS (Fondo de Solidaridad e Inversión Social, or Social Investment Solidarity Fund) annually helps 120,000 vulnerable people in Chile to find a job or to start a business.

While microlending in LATC has been an example of steady growth, large variation within countries still exists. For example, in Peru 44.4% of people below the poverty line have access to microcredit, while in Haiti only 1.5% of people below the poverty line have this access.

Cost Structure and Importance of Loan Officers

Microcredit is an expensive service; average interest rates on the order of 30% per year might even look abusive. However, once you do the math, microcredit loans seem to be fairly priced. In figure 3, we present a simplified analysis of the price and costs of microcredit.¹ Historically, interest rates in LATC have been higher than in South Asia, but the gap is mostly explained by a difference in costs. The margin between price and costs has narrowed over time in both regions, getting close to zero in South Asia and to around 3% in LATC by 2011. In figure 4, we see that microcredit institutions' return over assets in LATC has gone down over time, reaching 3% in 2011, which is consistent with our cost analysis. Surprisingly, NGOs have been more profitable than for-profit institutions, but the gap in profitability has disappeared over time. In South Asia, NGOs also have been more profitable than for-profit institutions. Furthermore, for-profit institutions experienced a significant loss in 2011, while NGOs returned 5% over assets in the same period.

Table 1. Microcredit Market in LATC

Country	i	ii	iii	iv	v	vi
Peru	60	8.77	3637566	2410	12.4%	44.5%
Colombia	30	5.31	2289703	2320	4.9%	14.3%
Bolivia	25	3.05	1026190	2970	10.2%	19.8%
Ecuador	45	2.23	845309	2641	5.8%	20.2%
Mexico	59	1.99	6067058	328	5.3%	10.3%
Brazil	22	1.84	2007737	916	1.0%	4.8%
Chile	5	1.64	263756	6217	1.5%	10.1%
Paraguay	6	0.99	500660	1970	7.6%	23.5%
Dominican Republic	10	0.64	407570	1581	4.1%	10.0%
El Salvador	13	0.37	148256	2487	2.4%	5.6%
Nicaragua	22	0.27	315248	866	5.4%	12.6%
Honduras	22	0.26	180114	1451	2.3%	3.5%
Guatemala	19	0.20	367722	539	2.5%	4.6%
Venezuela, RB	2	0.15	44874	3436	0.2%	0.5%
Haiti	6	0.07	116828	616	1.2%	1.5%
Costa Rica	14	0.07	16445	3963	0.3%	1.4%
Argentina	13	0.04	39915	1053	0.1%	
Panama	3	0.02	14866	1489	0.4%	1.3%
Jamaica	2	0.02	13895	1184	0.5%	2.9%

Columns: (i) number of microcredit financial institutions; (ii) total lending in US\$ billion; (iii) number of clients; (iv) average loan size US\$; (v) percentage of clients with microcredit (over total population); (vi) percentage of clients with microcredit (over population below poverty line).

In figure 3, we also observe that salaries account for a 10% cost as a fraction of the total loan volume, which represents one-third of the total costs.² The rest of the costs, not displayed in the figure, are distributed as follows: one-third goes to administrative expenses, a little more than one-sixth goes to cover financial expenses and other operative expenses, and the remaining cost is the loan expected loss, which is the cost imposed on the system by the borrowers that do not pay back.³ While administrative costs as one-third of total costs (or 10% as a fraction of total loan volume) seem high, we have to keep in mind that the administrative work to issue a \$200 loan is not too dif-

ferent from the administrative cost to issue a \$10,000 loan. Therefore, in relative terms a smaller loan will be more expensive.

The cost analysis shows how important labor is in the microcredit industry both in LATC and in South Asia.⁴ In particular, more than 50% of the employees in a microfinance institution are loan officers, which are crucial in the lending process. Indeed, loan officers play a fundamental role in screening potential borrowers, making credit assessments, and monitoring the borrower over the loan cycle. These tasks are particularly challenging in the microcredit industry because, as opposed to large companies, the repayment capacity of

a microcredit borrower cannot be obtained from formal records like balance sheets or income statements. Actually, many of these borrowers do not even have informal record keeping, as seen in the examples at the beginning of this article. The lending is then based on the perception of the loan officer about the borrower. The variables used by the loan officer to form a perception about the client are often referred to as “soft information”; this information is usually private and tacit.

It has been shown in the management and social literature that a close and trusting relationship between the loan officer and the borrower is seen to be instrumental in obtaining “soft” information. Thus, loan officers need to gain the trust of the borrower, which requires costly time. This limits the number of clients that a loan officer can have in his/her portfolio. In Latin America, the median number of clients per loan officer is 260, while it is 320 in South Asia.

A recent study by Drexler and Schoar (2012) conducted in a large bank in Latin America measures the importance of the social relationship between the loan officer and the borrower. In particular, it measures how the credit capacity of the borrower as well as repayment behavior are affected when a loan officer has to be absent unexpectedly for a long period of time. During the absence of the original loan officer, the credit availability for the borrower (measured as access to new loans) is reduced by almost 20%, and the probability that the borrower stops paying the loan installments shoots up by more than 20%. Furthermore, clients are also 10% more likely to get credit in other banks, which might indicate a decrease in the loyalty of the client toward the original bank. All the findings in the study point to first-order implications of the social relationship between the loan officer and the borrower in the lending process.

All in all, the high interest rates are a consequence of a very costly lending process and not related to companies making outrageous profits. In practice, microlending still represents a significant reduction in the lending costs for this segment of the market that would otherwise borrow from loan sharks, who charge rates that can be as high as 100% a month.

Figure 3. Cost Analysis: South Asia vs. Latin America and the Caribbean

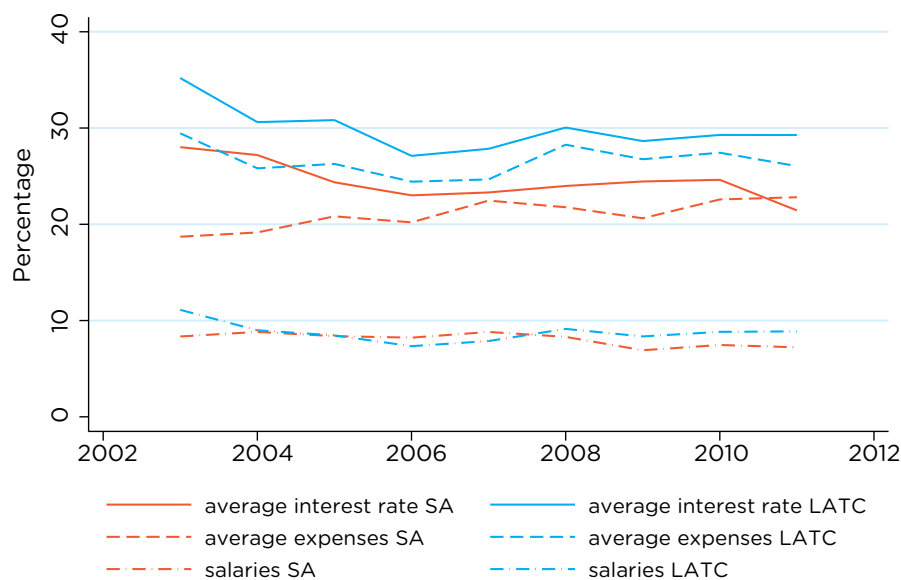
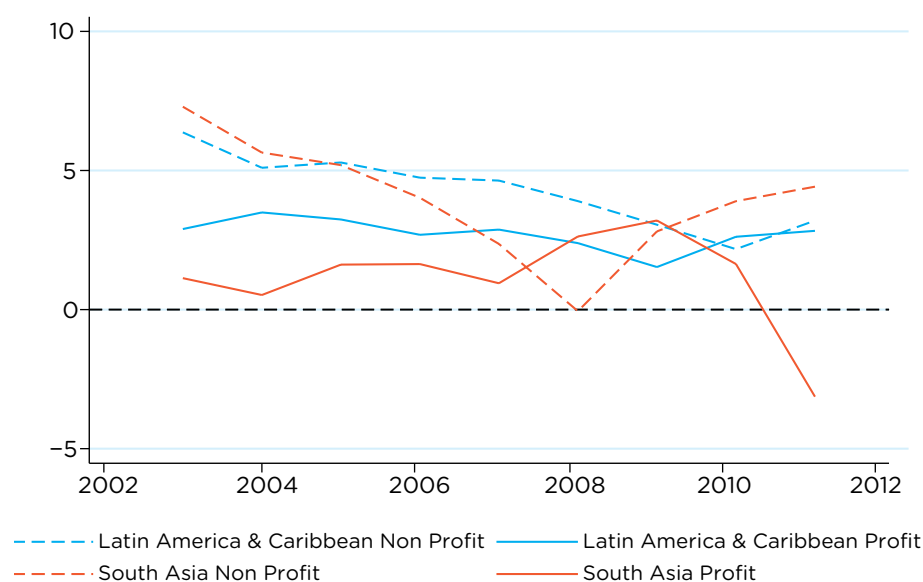


Figure 4. Return Over Assets



Microfinance Effectiveness

Microfinance proponents often stress the importance of expanding access to microfinance, and use the ratio of the number of borrowers to the people in need as a measure of poverty reduction. In all of LATC, 10.4% of the people under the poverty line are serviced by microcredit. This compares to 29% in all of South Asia. Peru stands out

as an outlier in LATC with the highest market penetration of 45%, similar to the 44% penetration of South Asia’s leading and most referenced example, Bangladesh.

However, the reach of microfinance is not necessarily a good measure of success; some people below the poverty line may prefer to seek a potentially safer form of employment rather than starting their own business.

Thus, it is possible to observe a successful microcredit market with low penetration. For example, if 95% of the people under the poverty line prefer to get a job, then a microfinance penetration of 5% would satisfy all microcredit demand. In practice, we do not know the actual demand for microcredit or the fraction of people who have funding constraints, but it is clear that significant room for growth still exists. On a global scale, Deutsche Bank Research (2007) estimates a market potential of 1 billion borrowers worth US\$275 billion of funding demand. This leaves a funding gap of close to 900 million borrowers and US\$185 billion.

But even satisfaction of demand might be a misleading measure of effectiveness. The real question is not whether entrepreneurs get microcredit but whether they benefit from it. CGAP, a branch of the World Bank, concludes that microcredits are valued by their recipients as there is little to no advertising need, a very high repayment percentage, and the willingness to pay high interest rates. Based on the CGAP findings and assuming that rational economic agents getting microcredit financing is beneficial, borrowers otherwise will reject the loans. Critics, however, warn of potentially detrimental overborrowing and increased indebtedness. To sort out these different opinions, one has to focus on specific welfare measures and see how these increase or decrease with the expansion of microfinance.

Proponents of microfinance associate several benefits with the provision of credit services: the eradication of hunger and poverty, gender equality, health improvements, and better education. The effectiveness of microcredit in these dimensions is difficult to measure because we often lack data to the contrary. For example, while we suspect that Peru’s flourishing small business activity has improved people’s lives, we cannot reject the possibility that things might have been equal or better without microfinance. An alternative to address this concern is randomized trials, where a fraction of the population is offered microcredit and the other fraction is not. While this type of evaluation is theoretically correct, it might prove to be extremely difficult to implement, either for operational or political reasons.

In the first randomized evaluation of the impact of microcredit, Banerjee et al. (2010)

find that access to microcredit increases total borrowing, number of new businesses, and expenditures on durable goods, especially durable business goods. However, no effect on average monthly expenditure per capita was found—indicating no improvement to well-being. The extent to which expenditures on durables cannibalize consumption of nondurables varies largely from household to household and also depends on their propensity to become business owners. While the study does not find a short-term increase in consumption, the observed increase of investment might generate a delayed increase in consumption they are not able to capture. Moreover, Banerjee et al. find no impact of access to microcredit on health, education, or gender equality. Again, delayed impact might be assumed in these cases as well and needs further research. A setup like the one in Banerjee et al. is difficult to replicate, and thus its results have been difficult to confirm. Nonetheless, their study suggests that microcredit does not seem to have the strong effect on economic growth that we would expect, or at least not in the short term, which might be discouraging.

The fact that we observe conflicting evidence regarding the effectiveness of microcredit might indicate that entrepreneurs have difficulties making efficient borrowing decisions, that is, some entrepreneurs might take loans that cost more than the benefit they generate. This is not surprising given that many studies have detected that the general population does not have the minimal skills required to make basic financial decisions on credit and savings.

Several financial institutions and NGOs have high hopes that financial literacy might improve the financial decisions of low-income people, making microcredit more effective. The potential benefits of financial education programs also have captured the attention of researchers.

A first study conducted in Peru examines the impact of teaching basic finance concepts to microentrepreneurs, and finds a large impact on the microfinance institution clients' knowledge of financial terms and reported business practices (Karlan and Valdivia 2011). Results are more mixed on real outcomes such as sales or consumption.

A study in the Dominican Republic takes a closer look at the real implications of financial

literacy, Drexler et al. (2010). A novelty in this study is that two different types of training are tested; a standard account-keeping training and a more basic rule-of-thumb training that focuses on a simple premise: If you separate the cash of the business from the cash of the household, you will be able to see at the end of the week or month whether or not you have made a profit. The authors show that the rule-of-thumb training was implemented more often, but they also find that the people implementing it were able to increase sales during bad weeks. These results indicate a better ability to manage cash once entrepreneurs are able to identify profits.

The findings in the former studies hint that given the right financial education, borrowers might better understand whether a loan will increase or decrease their business outcomes. This can significantly improve the overall effectiveness of microcredit. Yet, implementing impactful financial education programs is still a challenge for most banks in Latin America and the Caribbean. Currently, only three of the twenty-five largest microfinance institutions in the region have financial education programs for their borrowers.

It will be interesting to measure the impact of microcredit after these financial education programs are implemented on a large scale. One hopes that the right combinations of microcredit and financial education programs will unambiguously show a positive effect on economic growth. Such a study is yet to come. ✨

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Notes

1. Both price and costs will be expressed as a fraction of the total loan outstanding, and price over total loan outstanding will be referred to as “the interest rate.”
2. Salaries are 10% as a fraction of total loan outstanding, while total costs are 30%.
3. For example, if the total loan volume is 100 million but it is expected that 5 million is not going to be recovered, the issuer of the loan must increase the interest rate by 5% to cover this expected loss.
4. The relative importance of labor is similar in

other regions of the world but for brevity is not presented in this study.

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