

Competition Works: Driving Microfinance Institutions to Reach Lower-Income People and the Unbanked in Peru

Competition from commercial banks is prompting microfinance institutions in urban areas of Peru and other Latin American nations to provide more service to lower-income groups. Where higher-income clients are already served by commercial banks, microfinance institutions compete by attending to a new demographic, while continuing to serve higher-income clients where commercial banking services are scarce.

Microfinance Institutions

Microfinance seeks to remedy credit market failures and the poverty they can engender. Providing modest amounts of capital to both small entrepreneurs and households can result in additional business income as well as liquidity for a wide range of needs. The rapid growth of the microfinance industry over the past 15 years has served approximately 130 million clients, according to recent estimates, yet it still reaches less than 20 percent of its potential market—the world's three billion or more lower-income people.¹

The main microfinance lenders are nongovernmental organizations, non-bank financial intermediaries, and microfinance banks. As the industry has expanded and matured, it has allowed the private sector to become increasingly active in providing financial products and services to low-income populations in emerging economies, demonstrating that the sector can be commercially sustainable.

The question, then, is, *can the development community use market-altering mechanisms to shift the strategic focus of microfinance institutions (MFIs) to serve these communities?*

Also, could this ultimately trigger an increase in microfinance lending to lower-income and other unbanked populations?

“Competition is the act of endeavoring to gain what another endeavors to gain at the same time,” wrote English essayist Samuel Johnson.² And when multiple firms or

industries compete for the same clients or customers in a market, the result can be a fundamental change in the dynamics of that market.

Moreover, intense competition can also create or expand a market. The market for financial services is not immune to this process. This critical market can be altered fundamentally by the introduction of new competitors, and more generally through the spillover of ideas and the creation of new networks.

Such alterations can drive financial services providers to cater to additional groups, and often marginalized ones. These groups include lower-income individuals, women, rural populations, and others that were previously



An MFI client engaged in the bakery business.

Source: Grameen Foundation

unbanked or underbanked. This alteration and expansion of markets has been observed in Latin American countries, where it has contributed to enhanced economic opportunity and increased inclusiveness in the region.

Affirmative responses to these questions would be helpful for development finance institutions such as the International Finance Corporation,* as well as impact investors, whose challenge is to infuse operational business models with a larger focus on markets, rather than a traditional and narrower focus on individual investments. Doing so could potentially produce a bigger impact on lower-income and marginalized groups, as well as contribute to inclusiveness and sustainability.

A recent IFC study investigated the poverty outreach efforts of fourteen MFIs across six countries in Latin America, including Peru, Colombia, Bolivia, Ecuador, Guatemala, and Nicaragua.³ The study leveraged information collected by these MFIs on poverty likelihood using the Poverty Probability Index (PPI), which is a statistically sound yet easy to use country-specific tool⁴ used to measure poverty in target markets. This information was supplemented with in-depth interviews with industry experts in the sector, as well as leaders of the MFIs.

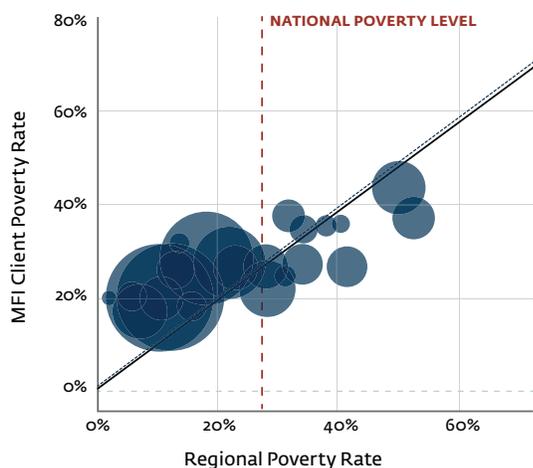


FIGURE 1 A Peruvian MFI serves lower-income people where competition is high, and the unbanked where competition is lower.

Source: “Factors Influencing Poverty Outreach Among Microfinance Institutions in Latin America – A report by the Grameen Foundation and the International Finance Corporation.” The red vertical line represents the percentage of lower-income households at the national poverty level in Peru, and the size of the circles the number of clients served by the MFI. The black line represents a 45-degree angle.

*The International Finance Corporation, or IFC—a sister organization of the World Bank and member of the World Bank Group—is the largest global development institution focused on the private sector in emerging markets.

The study found two interlinked factors driving the market focus of MFIs across these countries: competition and overly high levels of debt.

MFIs reached more lower-income clients in regions where there was higher commercial banking saturation, despite the fact that the MFIs may not have targeted these groups initially. Commercial banks in these typically urban areas tended to serve higher-income clients, so market forces—in the form of new competition for customers—encouraged the MFIs to expand their service offerings to individuals lower on the income ladder.

In addition, MFI leaders who were interviewed said that high debt levels among higher-income clients in urban areas precluded those clients from additional borrowing, and so forced the MFIs to expand their service offerings to lower-income clients with less debt.

Robust competition from commercial banks in urban areas also led MFIs to shift the *geographic* focus of their operations, from cities to suburbs and rural areas. In these non-urban areas, the MFIs tended to serve relatively higher-income, but still unbanked, individuals. Another study found that MFIs also benefitted from the additional revenue derived from cross-selling products to rural clients.⁵

Figure 1 depicts the market focus of a typical Peruvian microfinance institution. In regions with less poverty (to the left side of the horizontal axis), MFIs are being forced by competition to serve poorer individuals. That is, their customers tend to be poorer on average *in that region*, and so sit above the sloping black line. Banks in these areas are serving relatively higher income people, so MFIs seek different, lower-income customers.

In regions with higher poverty rates (to the right on the horizontal axis), where banks tend to be less competitive, the MFI’s customers tend to be higher income (so below the black line).

This Peruvian MFI shown in Figure 1 is an example of how competition can push an institution to target underserved segments of the market. Essentially, the MFI serves more lower-income households in geographic areas where they are more scarce (that is, areas with higher-income populations). However, in geographic areas with higher percentages of lower-income households, the MFI is serving higher-income households.

According to interviews conducted for the study, the clients served by the MFI in areas of high banking saturation (where the bubbles are above the black line) were more often lower-income and had no access to the lower interest rates offered by commercial banks.

Microfinance lenders that do not explicitly focus on serving lower-income people are often pushed to do so by increased banking saturation. In-depth interviews with industry experts and MFI leaders across the region confirmed that this is due to the fact that, when commercial banks enter a market, MFIs are unable to successfully compete with the

generally lower interest rates offered by those banks. **Thus, they move their operations to suburban and rural areas in search of underserved clients.** Most of the MFIs included in this study cited banking saturation as a key factor when deciding which regions to enter.

This is also illustrated by Figures 2 and 3. They show in green the regions where the same Peruvian MFI has a higher percentage of lower-income clients than the poverty rate in any given region. They also show in red the regions where the same Peruvian MFI has a lower percentage of lower-income clients than the poverty rate in any given



FIGURE 2 A Peruvian MFI, with generally higher percentage of lower-income clients in urban areas

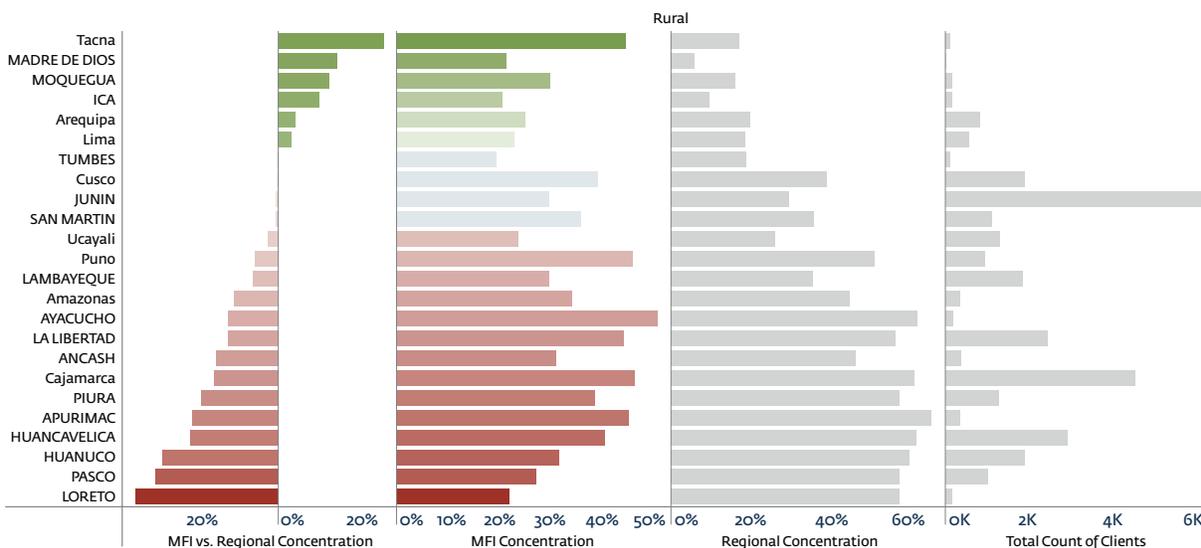


FIGURE 3 The Same Peruvian MFI as shown in Figure 2, here shown with generally lower percentage of lower-income clients in rural areas

Source for both figures: “Factors Influencing Poverty Outreach Among Microfinance Institutions in Latin America – A report by the Grameen Foundation and the International Finance Corporation”; Note: Concentration refers to percentage of lower-income people (e.g., MFI Concentration is the percentage the percentage of MFI clients who are living under the poverty line)

region. Therefore, urban areas are predominantly green in Figure 2, and rural areas are predominantly red in Figure 3.

The study also found that those MFIs that reached the highest percentage of lower-income clients were the ones with a specific strategic focus in areas with higher percentages of lower-income people. Moreover, several of these MFIs explained that they designed their products (for example, loan size and training) to cater to lower-income clients in areas of high competition.

This demographic shift is also motivated by the need for MFIs to be profitable, as the industry has changed from one in which MFIs are typically non-governmental organizations to one in which they are for-profit institutions.⁶ Forests, highlands, and mountain areas all have lower percentages of lower-income clients in the MFI portfolios. Given that these are often the poorest areas, the MFIs were focusing their commercial strategies there on relatively higher-income clients. They were also facing little or no competition from other financial institutions in these areas. Across the countries reviewed, the study found that MFIs reach the lowest percentages of lower-income households in regions with lower population density and challenging geographies.

The studies also found that:

- The higher the income of an MFI client, the larger the average loan size and the number of loans that client receives. However, this relationship is less significant in areas with a higher percentage of lower-income households.
- Women tend to receive smaller loans than men, but they tend to receive loans more frequently. These women are typically the head of household. According to interviews, as women have fewer opportunities to receive a loan, their opportunity cost of defaulting is higher.
- The higher the number of loans received by a client, the larger the size of subsequent loans. This trend is particularly significant in Peru and Guatemala, and seems to be a reward for good financial behavior, but was less significant in Ecuador and Colombia where MFIs have greater concerns about client debt levels.

- Microenterprises are more likely to see finance as a key constraint to their development and more likely to be disadvantaged in economies with underdeveloped financial systems.

Conclusion

Competition from commercial banks for higher-income customers in several Latin American countries, and particularly Peru, encouraged microfinance institutions to expand their service offerings to lower-income people and the unbanked.

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ADDITIONAL EM COMPASS NOTE ABOUT THE PROVISION OF FINANCIAL SERVICES IN EMERGING MARKETS

Please note the following related earlier EM Compass Notes: How Fintech is Reaching the Poor in Africa and Asia: A Start-Up Perspective (Note 34); Digital Financial Services: Challenges and Opportunities for Emerging Market Banks (Note 42); Blockchain in Financial Services in Emerging Markets - Part I: Current Trends (Note 43); Blockchain in Financial Services in Emerging Markets - Part II: Selected Regional Developments (Note 44).

¹ IFC. "Microfinance." Brief, no year. https://www.ifc.org/wps/wcm/connect/Industry_EXT_Content/IFC_External_Corporate_Site/Industries/Financial+Markets/MSME+Finance/Microfinance/

² The Library of Economics and Liberty. www.econlib.org/library/Topics/HighSchool/CompetitionandMarketStructures.html.

³ Rebolledo, Miguel, Terence Gallagher, Sergio Correa Asmar, and Julie Peachey. 2016. "Factors Influencing Poverty Outreach Among Microfinance Institutions in Latin America – A report by the Grameen Foundation and the International Finance Corporation." IFC, Grameen Foundation.

⁴ <https://www.povertyindex.org/about-ppi>; see also Burke, Laura, Sharada Ramanathan and Miguel Angel Rebolledo Dellepiane. 2018. "A Practical Tool to Create Economic Opportunity for Low-Income Communities", EM Compass Note 56, IFC, July 2018.

⁵ Paniagua, Gloria and M. Lynch. 2015. "Systematic Review of SME Banking and Business Regulation." IFC.

⁶ NGOs typically tend to measure success as poverty outreach.